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Vývoj a rozdiely v štruktúre daňových príjmov v krajinách OECD so zameraním na daň z príjmu fyzických osôb

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DIPLOMA THESIS

Development and Differences in Structure of Tax Revenues in the OECD Countries, with an Emphasis on Personal Income Tax

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Chcela by som poďakovať svojmu konzultantovi, Doc. MPhil. Ondrejovi Schneiderovi, Ph.D. McKinsey Chair za cenné pripomienky k diplomovej práci. Za trpezlivosť a pomoc ďakujem predovšetkým svojej rodine a Ing. Romanovi Žovincovi.

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Prehlásenie: Prehlasujem, že som diplomovú prácu vypracovala samostatne a použila som len uvedené pramene a literatúru.

Hereby I declare that I compiled this thesis independently, using only the listed literature and resources.

Prague, 20 June 2006

Linda Balážiová

Abstrakt

Prvotným cieľom práce je preskúmať vývoj daňových systémov krajín OECD. Kladie si tiež za cieľ určiť podobnosť i rozdiely vo voľbách krajín OECD ohľadom stupňa, štruktúry a systému zdanenia; v mnohých prípadoch za posledných štyridsať, alebo päťdesiat rokov. Práca sa snaží zachytiť niektoré z týchto výberov rôznych krajín, ktoré neboli uskutočnené v žiadnej inej krajine OECD.

Práca podáva výklad toho, čo sa zmenilo a čo ostalo rovnaké, ako i povahy a možnosti daňových reforiem krajín OECD do budúcnosti. Poskytuje čitateľovi porovnania medzi krajinami, sústrediac sa prevažne na to, ako ďaleko zašli tieto spoločné trendy a postoje vo vývoji, do akej miery šli krajiny svojou vlastnou cestou a ako pravdepodobné sa zdá, že budú v svojej ceste pokračovať v niekoľkých nasledujúcich rokoch.

Abstract

The primary aim of the paper is to examine tax systems developments of the OECD countries. It also aims at identifying similarities and differences between the main choices of the OECD countries, with regard to tax levels, structures and systems: in many cases over the last forty or fifty years. The paper also tries to pick up some choices made by particular countries, not to be found elsewhere.

It describes what has changed and what has remained the same, as well as the nature and likelihood of tax reforms of the OECD countries in the future. This paper provides comparisons between the countries, concentrating in particular on how far common trends and attitudes have emerged, how far countries have gone their own way and seem likely to continue to do so over the next few years.

Table of contents

1. Introduction

The primary aim of the paper is to examine tax developments of the OECD countries over the last forty years and to describe what has changed and what has remained the same, as well as the nature and likelihood of tax reforms of these countries over the next few years. This overview provides comparisons between the countries, concentrating in particular on how far common trends and attitudes have emerged, how far countries have gone their own way and seem likely to continue to do so over the next few years.

Paper is divided into 6 chapters. What is generally summarized in the introductory chapter is discussed in greater detail in subsequent chapters. The chapter looking at individual countries (in different OECD regions) is preceded by three general chapters that discuss issues which are not country-specific. Chapter 2 is devoted to trends in tax policy, where in the subchapter the tax trends in the last fifty years by decades are described. Personal income tax, with its history and structure, is the main topic of the Chapter 3. Family taxation and taxes on labour and work supply are further outlined there in 2 subchapters.

Chapter 4 illustrates possible choices in the design of the main taxes in the OECD countries. It is divided into Europe and Non-Europe OECD region, where country coverage is restricted to chosen OECD countries. This chapter aims at identifying similarities and differences between the main choices of the OECD countries, with regard to tax levels, structures and systems, in many cases over the last forty or fifty years. The chapter also tries to pick up some choices made by particular countries, not to be found elsewhere.

Chapter 5 offers a few guesses on how tax systems might evolve over the next fifteen to twenty years, and ends up with the question: "Will tax systems converge?"

Use of acronyms

For the personal income tax, I frequently use PIT. I frequently use CIT for corporate income tax, and SSC for social security contributions and VAT for value-added tax. DIT is used for dual income taxes. TTR is being used for the ratio of the total tax revenues to GDP.

2. Trends in Tax Policy

2.1. *Introduction*

The world of taxes changed a lot since the year 1900. Tax levels increased almost fourfold and main sources of tax revenues have completely changed. In 1900, the greater part of government revenues was driven from selective taxes on consumption (import duties and excises) with property taxes on land and buildings, then as now providing revenues for local government being the next most important revenue source. In some countries, in 1900, there was a relatively unimportant personal income tax (PIT) on the rich few, though never a capital gain tax. In those days, corporate income taxes (CITs), social security contributions and general consumption taxes were virtually non-existent. The rise in the tax levels over the twentieth century as a whole was due to the introduction and subsequent increase of four new forms of taxation:

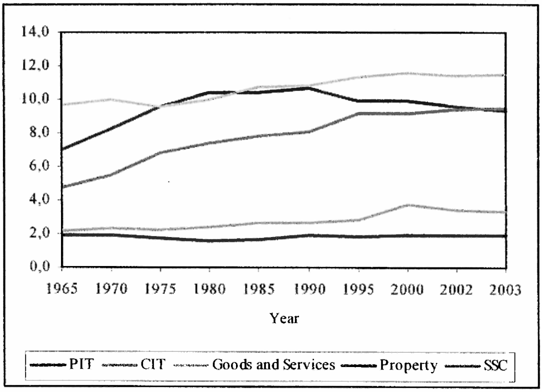
1. The personal income tax, usually introduced between 1880 and 1920, had by the end of the World War 2 (in 1945) been transformed from elite to a mass tax.
2. Between the two World Wars, most industrialized countries adopted general consumption taxes, taking the form of cascade taxes in central and Eastern Europe and single-staged sales taxes elsewhere. Both were subsequently replaced by value-added taxes.
3. Also between the First and the Second World Wars, most countries introduced corporate income taxes, which since 1955 have tended to account on average for between 8 and 10 percent of government tax revenues.
4. Since the World War 2, the growth of the welfare state has led to introduction and/or rapid increase of social security contributions.[1]

Such important revenue raisers of 1900 nowadays play second violin to personal income tax, social security contributions and value-added tax.

Overall trends in tax mixes are illustrated in the Fig. 1.

[1] MESSERE 2003

Fig. 1 Revenues of main taxes as a share of GDP (1965-2003)
OECD average



Source: OECD (2005), own graph

A question is what constitutes a tax. There is a definition of taxes (according to OECD classification of taxes) as compulsory unrequired payments to general government. These payments are unrequired in the sense that benefits provided by governments to taxpayers are not normally in proportion to their payments.

The purpose of the OECD standardized classification is to compare the weight of taxation both between countries and in the same country over time. There is of course a number of additional sub headings, which further disaggregate certain taxes according to whom pays the tax (households or business) or whether they are recurring (usually annually) or once and for all.

2.2. Decades 1950-2000 – Generalization

We may summarize the tax trends in the last fifty years by decades and it could be on the following lines.

The 1950s were the decade of post war reconstruction when welfare state and public sector started to grow. There was corresponding growth in total tax revenues to GDP ratio (TTR) and especially in the ratio of social security contributions, for most countries the preferred way of financing a significant segment of the welfare state.

In the 1960s there followed economic growth and low unemployment levels. Fiscal policy was dominated by a new view that its main function was to act as an instrument to regulate aggregate demand, so as to reach the optimum trade-off between levels of inflation and unemployment. As a result of this interventionist attitude and political consensus for improving the welfare state, total tax revenues (TTRs) and especially PIT ratios, continued to rise at a great rate. Many of OECD countries were in budget surplus between 1960 and 1973.

In 1970s stagflation came. First oil shock came in 1973. Little worries were felt at the collapse of the fixed-exchange rate system or the commodity and food price boom. Move to value-added tax and spread of withholding of income taxes, enabled the upward trend of total trend revenues to continue. After 1974 the macroeconomic performance in the OECD area had deteriorated and it remained poor for the rest of that decade. This led to lot of questions whether the public sector growth remained appropriate and whether the efficiency of government interventions in the economy could not be improved. There was a slowing growth of total tax revenues and it was not matched by a slowing of public expenditure and from the mid-1970s fiscal deficits reached post-war records. Fiscal deficits peaked in year 1983, when very few countries were in surplus.

The 1980s brought a further decline in macroeconomic performance with unemployment levels often at record post-war high. From that times also comes the idea that tax distorts, and from the point of economic efficiency and equity, taxes should generally be as low and neutral as possible. The main effect on government choices was lowering of income tax rates, broadening of the income tax base and flattening of the personal income tax schedule. These changes were revenue neutral and overall total tax revenues continued to increase gently.

The 1990s began with a long period of economic downturn and in 1993, deficits reached 1983 levels. Most governments then started with reduction of deficits. After moderate increase in total tax revenues, a reduction in the growth of public expenditures and extensive privatization at the end of the twentieth century nearly all OECD industrialized countries were in surplus and only Japan (-7,4 per cent) recorded a deficit exceeding 1,5 per cent of GDP.[2]

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[2] data OECD

The Oil Shocks

The two oil shocks of 1973 and 1979-80 led most OECD governments to take a lot of tax measures to encourage the conservation of energy and a more rational use of oil. When there has been a conflict between energy policy, transport policy, environmental policy, or even tax policy, it was than energy policy that had the priority. All this have stopped by the mid-1980s when oil prices had already begun to drop. And these days environmental considerations probably had more influence on tax legislation then energy policy objectives. What was another consequence of oil shocks? It was the fact that in nearly all countries the excise tax on motor oils declined sharply in real terms between 1973 and 1982 but thereafter it increased. In the 1990s, crude oil prices increased to extreme heights and than plummeted again, but with much less effect on OECD economies and on tax measures than in 1970s.

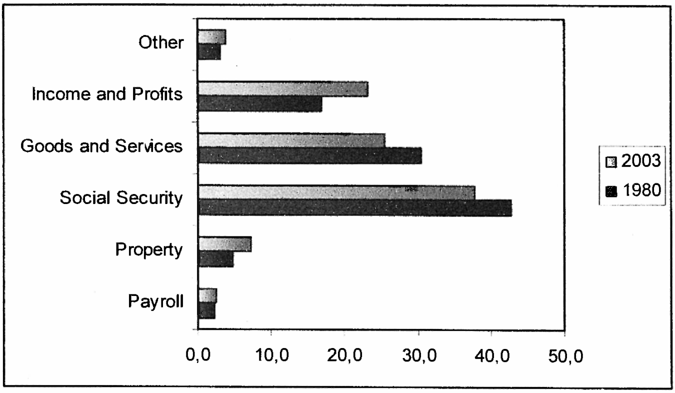
Fiscal Deficits

Fiscal deficits caused couple problems between 1960 and 1972. They became serious between 1975 and 1982 and declined again during most of the 1980s. From 1989 to 1993 nearly all OECD countries recorded deficit. This deficit was continuing and generally increasing. These days fiscal balance became very important to policymakers. This was especially the case of the European Union countries, which were obliged to reduce their deficits to below 3 per cent of GDP by 1998 as a condition of participating in the common currency area. Of course to reduce deficits there was necessary to increase total tax revenues. And this was probably the main reason why most OECD countries increased the standard rate of value-added tax (VAT) during the 1990s.

Political preferences

The left is supposed to prefer higher taxes (especially on income) and higher spending in order to increase the role of the public sector in the economy and to redistribute income. The right prefers the opposite. Even though in the period of sustained growth there was a political consensus in Europe to increase expenditure on the welfare state, no matter which parties (left or right wing) were in power. Right wing governments and their predominance in the 1980s and early 1990s contributed to the slowdown of the increase in total tax revenues. Since then, left wing governments have predominated during the late 1990s and right wing governments again during the early years of the twenty-first century. The impact on the tax policy was usually limited. Political preferences may be one factor influencing government choices on a variety of tax policy issues, for example capital gains taxation, the corporate tax system, the appropriate tax mix and the choice between tax credits and tax allowances. These preferences can affect tax laws.

Fig. 2 Tax revenue of main headings as percentage of total taxation, France



Source: OECD 2005, own graph

France may solve as an interesting example. A left wing government introduced the net wealth tax in France, in 1981. It was abolished by the right wing government next in power[3] and re-introduced by a left wing government in 1989.[4] Some governments` tax policy choices were influenced by political preferences[5] but other factors have influenced them in many cases much more.

Demographic Aspects and Social Influences

The first aspect of the last fifty years is the growing participation of women in the labour force. Nowadays we could observe a two-earner families and it is not

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[3] Net wealth tax was abolished in 1987.

[4] In 2003 out of €786 billion "general government" receipts, €174 billion was collected on "income and wealth". Data is from the Institut National de la Statistique et des Etudes Economiques.

[5] In 2004, Jean-Pierre Raffarin introduced legislation to reform French Social Security to cut costs, thereby reducing its deficit. In both cases, this government had reduced taxes or contributions. Opponents, mostly from left-wing parties but also, to a lesser extent, from the Union for French Democracy (a centrist party in the ruling coalition), contend that the proposed reforms are not good for the country and thus rightly opposed by the population. (INSEE)

an exception. The effect on tax legislation has been in most but not all countries to change the income tax liability of working couples from a joint to an individual basis. The effect of a change from joint to individual taxation in isolation was to reduce the tax liability of high-earning couples and increase it for the low-earning couples, so making the income tax less progressive. During the late 1980s and early 1990s many countries have been flattering the formerly steep rate schedules[6]. This has further reduced the importance of the choice of tax unit.

The second aspect of the last half century was the increase of the informal unions and one-parent families. Political and moral problem has arisen, how to treat the informal unions, including those with partners of the same sex. If it should differ from the treatment of married couples and if not, the technical problem arises, of how to cope if the partners of the informal union change. This has become a problem for tax legislation only during the last twenty years and country solutions differ. There is also a growing number of one-parent families. This, from the tax point of view adds to the importance of the existing unemployment trap for those whose benefits are high, compared to earnings and the reduction if they would enter the formal economy.

Another problem is ageing of population. The major problem is how far can be increased pension outlays financed by taxes on the future work-force and how far must they be financed through taxes and savings of the present work-force. This problem has become more important in recent years and its importance will still be growing in the future.

Environmental aspects

The tax system offers a lot of possibilities how to meet environmental objectives. One of them is to adjust existing taxes (charge unleaded petrol at lower rates, differentiating between petrol and diesel oil which pollute in different ways), the budgetary effects of which are insubstantial. A second option is to impose new green taxes, which is difficult because of the international competition reasons. Such green taxes are in force for example in Scandinavia, the Netherlands, and Italy. But they do not have special relevance to tax policy. Usually the principle that the polluter must pay is applied, but this is more likely to take a form of user taxes.

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[6] for example USA

Concept of externality means that some effects of an activity are not taken into account in its price. For instance, pollution in excess of the socially optimal level may occur if the prices a producer pays do not include the impacts (costs) experienced by those adversely affected.

Typically the greatest polluters do not appear to suffer any tax penalty. If such a polluter is a monopoly, or/and is of strategic importance to its home country (it may be, for example, power plant) this country does not have big incentives to levy ecological tax on it. The reason[7] may be (as mentioned above) that the increase in polluter's taxes will shift the tax burden to consumers, in the way of increased prices. A final option is to increase the heavy traditional excises especially on motor vehicles and motor fuels.

Employment Policy

Several countries have used the tax system in an attempt to increase employment, especially during last decade. They introduced non-wastable tax credits for the working poor, some countries also provide reduced employers` and/or employees` social security contributions for certain industries or for the young, for women and for part-time workers. Hutton and Ruocco (1999) have suggested that moves from PIT to VAT in Germany, Italy and the United Kingdom may have had beneficial effects on employment.

Cnossen (2001) provides a comprehensive review of the trade-offs involved in using the tax system to promote employment with other goals such as alleviating poverty, increasing productivity and stimulating both the supply and demand for labour. Generally, little can be done to increase employment through the tax system without damaging other policy goals. An exception perhaps is tax/benefit provisions targeted to women and part time workers. Decisions of married women to enter the labour force are also influenced by the availability of cheap child-care facilities and cultural attitudes. Different types of taxpayers are likely to respond in different ways to tax changes. This is not only a question of hours worked, but includes readiness to change work location, age of retirement and the form work takes (for more details see Subchapter 3.5)

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[7] other reason is lower international competition

Technological Progress

Technological progress has contributed to transformation of the relationship between tax inspectors and tax avoiders or evaders. With the aid of computers, tax inspectors can much easier detect tax evasion through, for example, electronic filing and audit selection techniques. But also tax avoiders are better armed due to the developments in communications technology. The internet renders such traditional benchmarks as “residence” and “source” are difficult to apply in practice. It is not very clear, how are the tax authorities going to be able to keep track of transactions carried out through the internet. The internet has not yet posed too many problems, but once fully commercialized it could have a profound effect on the form that taxation takes.

Administrative constraints

What the tax administration can deliver, may limit tax policy choices, especially in developing countries. Absence of sufficiently trained local government tax officials, among OECD countries, may have been one factor inhibiting tax decentralization. In the mid-1980s, Australia did not go for a VAT largely, because it would have then taken too long to implement. Australia has had to wait for more than ten years for another try. Generally any major tax reform has to face the test whether it is worth the administrative costs and social upheaval that may be involved.

3. Personal Income Tax

Personal income tax belongs in the world to standard instruments of fiscal policy. Apart from its fiscal function, it carries also redistribution and stabilization function. Almost in all OECD countries it is constructed as progressive, where, with the increase of taxpayer's income it moves towards the higher rate.

It is used to promote many, not always compatible goals, such as vertical equity, horizontal equity, economic efficiency, neutrality towards various kinds of social and economic decisions.[8] There is also a variety of instruments at governments` disposal for promoting their priority objectives, such as different ways of giving tax relief, aggregation or non-aggregation of spouses` income, different degrees of progressivity of rate schedules and offsetting wholly, partially or not at all the impact of inflation. All these instruments interact with each other in determining the tax burdens of different categories of taxpayers.

These taxes recorded after the World War 2 the double development. At the beginning came an increase of the amount of the tax rates. Conversely number of tax rates and their decrease occurred during 1980s of the last century. On the other hand came the widening of the tax base, where a number of non-standard deductions were abolished and their use was constrained. Taxes are not levied, or are very low in some countries, which are considered to be a tax paradise. OECD acted against some of these countries and it accused them from tax dumping, in recent years.

3.1. The rationale for PIT

The belief that the individual tax is the fairest of all taxes arises from the conviction that it accords best with the ability to pay. Net income is a measure of a person's capacity to command economic resources, and, intuitively, it seems to be a good indicator of ability to help finance government.[9]

Over the course of 1970s, the PIT moved from being perceived as the most fair to the least fair in the United States[10]. This increasing dissatisfaction, which extended beyond the United States, was primarily due to the combination of an

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[8] MESSERE (2003)

[9] GOODE (1976)

[10] SLEMROD (1996)

economic downturn and increasing inflation, with the consequence of higher income tax burdens when real incomes had almost ceased to grow. These spotlighted defects in income tax systems had been hidden during the previous fifteen years of strong economic growth.

Fairness of progressive rates was nullified by expense-related tax reliefs, which enabled many types of taxpayers (businessmen, liberal professions, farmers) to reduce their income tax liabilities, so that the income tax burden was increasingly borne by employees. Governments and academics became aware that existing income tax systems might distort savings, investment, financing and production decisions.[11] They became persuaded that these had negative effect on the level of household saving and on labour supply. Proliferation of tax reliefs, different treatment of various kinds of income, and too much rate bands (sometimes over thirty) had rendered the income systems of most industrialized countries extremely complex with correspondingly high compliance costs and loss of certainty. By the late 1970s there has been a growing consensus that the existing income tax systems infringe equity, efficiency and simplicity. Thus they have had a little rationale and it was essential that they should be either replaced or reformed.

The view of the most policy makers was that the PIT should be replaced rather than reformed, between 1975 and 1985. During this period, proposals emerged from a number of public finance economists as well as tax reform commissions in Ireland, Sweden, the United Kingdom, and the United States to replace or supplement the income tax by a progressive expenditure tax. The base of such a tax would be consumer expenditures, replaced by total income plus gifts and bequests received, minus savings made. A progressive rate schedule would be applied to this tax base. Under most proposals, such a tax would be supplemented by a cash flow corporate tax, which would replace the traditional corporate income tax (CIT) as well as a progressive tax on the capital of emigrants and the deceased. The competing arguments for a reformed income tax and a progressive expenditure tax were widely debated between the mid-1970s and the mid -1980s.[12]

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[11] AARON et al. (1988)

[12] CNOSSEN and BIRD (1990)

The intensity of the debate subsided once the United States in 1986, followed by most other industrial countries during the next five years, opted for reform of the income tax, rather than for its replacement. To put it differently, governments found, that a reformed income tax had a greater rationale than the only possible alternative to raising sufficient amounts of revenue.

The question remained open, and still remains open, of how the income tax should be reformed to obtain the ideal maximization of equity, efficiency, and simplicity. The major thrust of the income tax reforms of the late 1980s, was that the then existing tax base was unnecessary narrow with respect to, for example, the treatment of capital gains, fringe benefits, social benefits and allowable deductions. When it will be combined with the rate lowering and reduction of the number of brackets of the rate schedule, a broader-based income tax would have greater justification in terms of horizontal equity, efficiency, and simplicity. On the other hand, during the 1990s, there has been a revival of the idea of moving towards a consumption base by eliminating some or all forms of saving from the income tax base on the ground that this would encourage aggregate household savings. Or it would reduce the present tax distortions between different forms of savings, some of which are tax privileged, while others are not. The recent lower flat rates applied to dividend and interest incomes (or their partial or full exclusion from the PIT base, in a number of countries) provide the most important practical examples of such base narrowing.

Here, I mentioned only the first question of why a traditional income tax continues to be universally preferred, even though for practical and policy reasons there remain many consumption tax elements in the tax base. There still remains many second-order policy issues within the income tax systems, such as their relationship with social security contributions and the associated benefits, the choice between income tax reliefs and direct expenditures, the income treatment of the one and two-earner families relative to each other and to single persons.

3.2. *History of Personal Income Taxation*

Personal income tax was for the first time introduced in the United Kingdom at the end of the eighteenth century to finance the Napoleonic wars. PIT became fairly widespread only towards the beginning of the twentieth century. Until the Second World War it remained a relatively unimportant tax in relation to revenues raised and numbers of the taxpayers covered. This is illustrated in the following table, which shows how the United States' federal tax evolved between 1913 and 1975. These fluctuations were influenced by the war 1914-1918 and especially 1939-1945 when what was a tax paid by few became a tax paid by most households.

Tab. 1 United States federal income tax

Share in total federal tax revenues								
1914-16	1917-20	1921-29	1930-40	1941-45	1946-49	1950-59	1960-69	1970-75
6,2	18,4	22,8	17,8	33,4	39,6	42,9	43,8	45
Percentage of population covered								
1913	1918	1926	1939	1945	1950	1960	1970	
less than 1	7,7	4,2	5	74,2	58,9	73,1	80,8	

Source: Goode (1976)

During the last half of the twentieth century the following broad revenue trends emerged in industrialized countries:

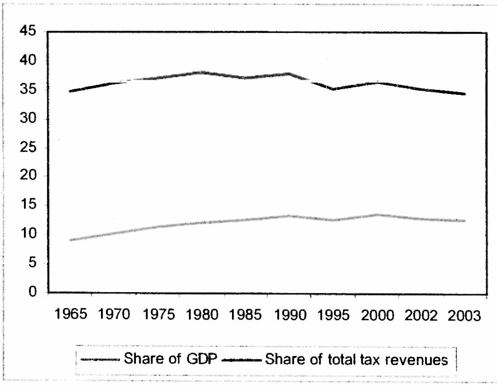
1960-1975: Income tax ratios increased mainly through fiscal drag and the bracket creep effect was accentuated as rate schedules became more progressive. On the other hand number of expense-related tax allowances increased thus narrowing the tax base.

1975-1990: Income tax ratios remained stable because fiscal drag was usually offset.

1990-2000: A relatively heavy fall in the income tax ratio between 1990 and 1995 (unweighted OECD average fell from 10,7 to 10,0) since when it has remained almost unchanged.[13]

[13] MESSERE (2003)

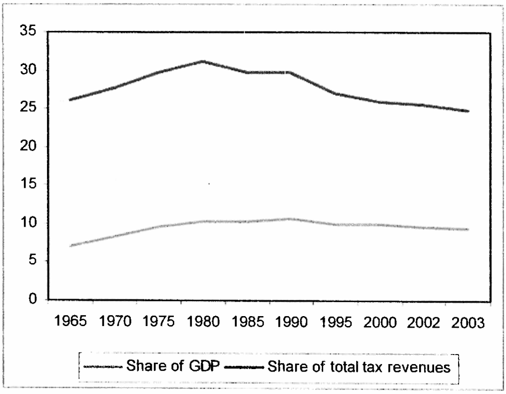
Fig. 1 Taxes on income and profits (1000) as percentage of GDP and total tax revenues (OECD average)



Source: OECD Revenue Statistics, 2005, own graph

PIT revenue trends are illustrated by Fig. 2, which provides OECD average PIT revenues as a percentage of GDP and total tax revenues at five-yearly intervals between 1965 and 2000 and than for years 2002 and 2003. It should be noted that the data are not entirely comparable, because the earlier series exclude a number of low PIT countries and the later series include for the first time countries which joined OECD later. Also, as already mentioned above, the average OECD PIT share conceals great variety between OECD countries. Fig. 3, which reproduces the PIT ratio and share in 2003, indicates the great differences among the selected countries.

Fig. 2 Taxes on personal income (1100) as percentage of GDP and total tax revenues (OECD average)



Source: OECD Revenue Statistics, 2005, own graph

3.3. The Procedures of Personal Income Taxation

The tax unit

Countries vary according to whether or not they aggregate for PIT purposes the earned income of spouses, where both are gainfully employed. In the countries where joint taxation is used, tax liability is calculated by applying the appropriate rate schedule to the aggregated taxable (earned) incomes of the spouses. Under individual taxation, tax liability is calculated by applying the appropriate rate schedule to the taxable earned income of each spouse.

Global and Schedular Tax Systems

The OECD trend has been mostly to move away from schedular taxation under which each source of income is subject to a separate treatment of rate and base towards global taxation where all income from whatever source is aggregated and one rate schedule is applied. However, OECD tax systems have been only relatively global in that sense, that pension funds and capital gains are sometimes not taxed at all, different allowances may be given to the employed, self-employed, farmers, and the liberal professions and different schedule rates may apply to earned, investment and agricultural income. Moreover, in recent years certain aspects of schedular taxation have been introduced in the North American and Nordic countries and the Netherlands.

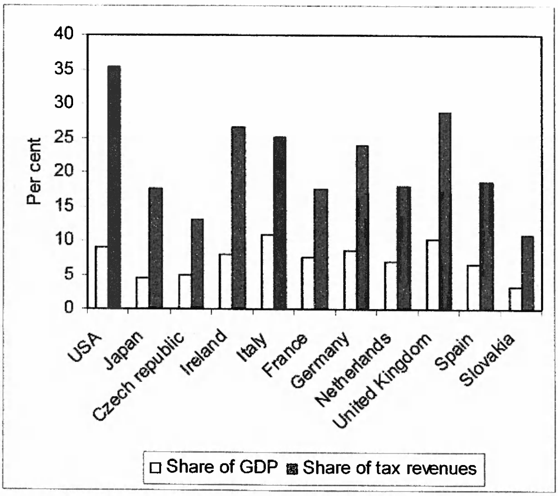
Tax reliefs

Tax reliefs are provided in a variety of ways in the OECD Member countries. We may summarize the main distinction between types of relief as follows.

Standard, and non-standard reliefs. These reliefs are unrelated to the actual expenditure incurred by the taxpayer and are available to all taxpayers that satisfy the eligibility rules. The tax threshold, under which no PIT is payable, is the one, which is the most important. There is usually this one threshold for all PIT payers and an additional one for those in employment. On the other hand, the non-standard reliefs, are reliefs which amounts are wholly determined by reference to the actual expenses incurred.

There are very important differences between standard and non-standard reliefs. The former are usually considered as part of the tax schedule and as an alternative to increasing marginal rates for achieving progressivity. The later are generally regressive and entail a further narrowing of the tax base. These non-standard reliefs are clearly tax expenditures, whereas it is arguable whether the same holds for the standard tax reliefs.

Fig. 3 Ratio and share of PIT revenues (2003)



Source: OECD Revenue Statistics, 2005, own graph

Forms of tax reliefs

Own tax duty (tax amount) could be counted by the following procedure:

- Taxable income is summed up
- Standard and non-standard reliefs are enforced (subtracted)
- Tax rate or formula for computing is applied on the arose tax base
- Computed tax can be further lowered by the tax allowances

This procedure is jointly exercised in all industrialized countries. On the other hand these steps are not uniformly interpreted.

In the first step countries differ in that sense, which incomes they are including into the tax base and which not. If after the half year of holding shares, I sell these shares with the profit; in one country is this profit subject to taxation in other it is not. In the same direction, the legislation connected to the point three differs among particular states. Number and levels of tax rates differ. States are also having different approach to point two and four. Firstly, what is considered by one state as a relief does not have to be a relief in the other state. Secondly, there are distinctions among countries in which way they offer the relief. The two forms of tax relief most widely used are known as tax allowances (tax deductions in the United States) and tax credits. Under tax allowances, there is a lump sum deduction from income potentially subject to tax, thus arriving at taxable income or the base to which the rate schedule applies. Tax credits are lump sum deductions from the tax due to be paid.[14] The important difference between tax allowances and tax credits is that the value of the former is a function of the marginal rate of the taxpayer. Thus, under progressive income tax schedules tax allowances are worth more to high than to low income taxpayers. Conversely, the value of tax credits is uneffected by the taxpayers` marginal rate of tax.

Generally, it holds, that relief in the form of deductible item lowers tax base, effective tax credits can be different between the two taxpayers, who had applied the same deductible item. To express the overall tax credit among the individual taxpayers is quite difficult. This approach is at the same time less transparent than

[14] Though normally the lump sum deduction from income subject to tax (in the case of tax allowances) and from the tax due (in the case of tax credits) is unrelated to income, in a few countries it has been related, sometimes positively, sometimes negatively, to income.

provision of the tax relief, where tax credit is the same for all taxpayers. Since a lot of tax credits have social character, it is interesting to watch their working together with the social system. This table presents the way of exercising tax credits of social character and tax credits on child in some OECD countries.

Tab. 2 System of tax allowances in chosen OECD countries

Towards to low incomes ←				→ Towards to high incomes	
Tax system / Allowances system	Regressive tax credit	Constant tax credit	No tax credit	Constant deductible item	Progressive deductible item
Regressive allowance	Italy	Poland		Czech republic	
Constant allowance (also zero)	Austria	Belgium	Finland	Luxembourg	France
		Denmark		Netherlands	
		Germany		Portugal[a]	
		Greece		Spain	
		Hungary		Sweden[b]	
		Ireland			

[a] *there exists also constant tax allowance in Poland*

[b] *Sweden has a more complicated construction of tax allowances, their level depends on the income*

Source: OECD (2001c)

In most countries, family status is generally taken into account by the use of tax allowances or tax credits but reliefs in respect of family status may also take the form of:

- Income-splitting systems (e.g. in Germany)
- Family quotient systems (e.g. in France)
- Separate schedules (e.g. in the United States).

Under income-splitting systems, whatever is the actual income of the two spouses, it is considered (for tax purposes) to be equal so that the schedule rate is applied for each to half their total income. Under family-quotient systems, taxable income is divided by further amounts to take account of the existence of certain dependents, most importantly minor children. The separate schedules systems are applying different rate schedules to single and married persons.

Collection procedures

Late and inefficient tax collection combined with high inflation poses a major problem, in the third world and in the transitional economies. Less so in industrialized countries, where tax is normally charged by reference to the income of a particular year, which may be the calendar year or some other period of twelve months. In some cases the tax is charged on the actual income received or accruing in the year, and in others, it may be charged on an amount calculated by reference to the income of the previous year. This process may vary not only from country to country but also, within the same country's tax system, from one source of income to another. The method of collecting of income tax affects, also, the amount of tax revenues, the speed of tax collection, the collection costs-to-yield ratio and the attitudes of taxpayers to the system. A lot of income tax revenues is provided by wage and salary earners, and in the OECD industrialized countries, other than France and Switzerland, tax is withheld along with social security contributions by the employers on income currently earned. Collection procedures appear to have an important effect on personal income tax revenues. For example, when Denmark in 1970 and Italy in 1977 moved to withholding at source systems, PIT revenues substantially increased. The fact that until 1998 France had the lowest PIT ratio of all industrialized countries is almost certainly not unconnected with its collection procedures.

There are also differences in the pay-as-you-earn systems. For example, under the British system there is cumulative withholding with no periodical adjustment. In most countries, there is an end-year adjustment to take account of tax underpaid, or overpaid. Also in some countries the tax authorities assess the taxpayers` liability whereas in others the taxpayer makes a self-assessment.

3.3.1. The tax base

There follow five specific areas where the tax base has been widened in recent years in a number of OECD countries.

1. The favourable treatment of fringe benefits, defined as all advantages, other than monetary salary and wages, in consequence of services rendered, or to be rendered, by an employee,[15] has resulted in a proliferation of this form of wage and salary payment.
2. The deductibility of premiums for retirement and insurance schemes has provided a large conversion of current income into future income.
3. The favourable treatment of imputed income from owner-occupied property is augmented by the favourable capital gains tax treatment accorded to sales

[15] (OECD 1988a)

of principal dwelling-places and sometimes to sales of two or more dwellings.

4. The deductibility of interest related to consumer credit expenditure still prevalent in a few countries has the effects of a negative consumption tax and discourages saving.
5. The frequent exemption from income tax of unemployment and other welfare payments could have work disincentive effects and seems unnecessary since such benefits could be grossed up to whatever level considered appropriate and taxed like other sources of income.

In their different ways, all five of these expenses-related tax concessions may distort consumer choices, discriminate against certain taxpayers and lead to a non-optimal allocation of resources. All except the last also reduce the progressivity of the personal income tax. There are good grounds for abolishing or reducing these concessions, as has been done in many countries during the last fifteen years, through political resistance to such base widening has remained strong.

The Relative Importance of Standard and Non-standard Tax Allowances

The most of decreases of a comprehensive PIT base are due to tax allowances. The main examples of non-standard allowances are:

1. Deductibility of mortgage interest payments combined with a preferential treatment of imputed rent
2. Deductibility of contributions to private pension schemes and a favourable treatment of the income of the pension fund and/or the pension payment.
3. Deductibility of premiums on life insurance policies combined with a partial exemption of the proceeds.
4. Exemption of interest payments received on national savings arrangements, post office savings, and bank deposits.
5. Tax exemption of interest received on government bonds.
6. Tax exemption or reduction of income from small investments in equities.
7. Tax incentives for private investments in equities to provide capital for productive investment.
8. Tax incentives for the purchase of employee participation shares.

9. Tax incentives for starting up or expanding a business.[16]

The range for widening the tax base by reducing or abolishing non-standard tax allowances varied considerably from country to country. Data in OECD (1990a) show that at the time these expense-related tax allowances varied from 22 per cent of income subject to tax in Denmark to 2 per cent in Spain. Mortgage interest relief usually represented the most important of these tax expenditures, being as a percentage of income subject to tax nearly 14 per cent in Norway, over 10 per cent in Denmark and between 4 and 6 per cent in the Netherlands, Sweden, United Kingdom and United States. Since then interest relief has been reduced or abolished in a number of countries. It all indicates the various possibilities governments have had at their disposal for widening the tax base.

OECD also provids quantitative data on tax allowances. Most important is the basic allowance available to all taxpayers. It amounted to over 30 per cent of income subject to tax in Canada and over 20 per cent in France, and the United Kingdom, though less than 10 per cent in Germany and Spain.[17]

The classification into standard and non-standard allowance is somewhat arbitrary with regard to work related expenses and social security contributions, both of which tend also to be quite important. Tab. 3 gives aggregate figures as a percentage of income subject to tax according to the classification that was provided by these countries.

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[16] MESSERE 2003 p.76

[17] Data OECD (1990a)

Tab. 3 Standard and non-standard tax allowances as a share of PIT revenues

Country	Tax allowances as percentage of PIT revenues		
	Standard	Non-standard	Total
Australia	0	10,3	10,3
Canada	20,8	7,1	28
France	29,3	0,1	29,5
Germany	7,1	17,6	24,7
Italy	0	5	5
Spain	5,1	2,1	7,2
Sweden	13,3	12,4	25,7
United Kingdom	34,5	9	43,5
United States	26,3	14,5	40,8

Source: OECD (1990a)

3.3.2. Tax schedule

There was a one way move in both OECD and non-OECD countries from what were unambiguously schedular systems[18] towards ambiguous global systems[19], until the mid-1980s. Since mid-1980s there has been a return in certain ways to schedular type taxation in North American and Nordic countries in two different respects; first, alternative minimum, or supplementary gross income taxes and second, dual income taxes, which are generally referred to as Dual income tax (DIT)[20]. In addition, another example of schedular taxation is provided by presumptive taxation of capital income in the Netherlands.

There are signs that quasi-schedular taxes will continue in the form of low flat rates (or even zero rates in some countries) on capital income, but probably not in the form of a pure dual income tax. Alternative minimum taxes and supplementary taxes on gross income have been much criticized and have not spread to other countries.

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[18] Each source of income is subject to different rates of tax.

[19] Differentiation according to different income sources is limited, if sometimes not all that limited.

[20] Dual income tax. A system under which capital income is taxed at the same flat rate as corporate income and at (around) the lowest marginal rate applied to labour income.

Alternative Minimum and Supplementary Gross Income Taxes

In the 1986 the United States put into practice Tax Reform Act. This Act introduced an alternative minimum tax under which higher income taxpayers were obliged to pay whichever is the greater of 21 per cent of their gross income or the normal rate schedule applied to their taxable income. Similar provisions exist in Canada. In the past, Norway has adopted a supplementary tax on gross income that is payable only by those with higher incomes.

Alternative minimum taxes or supplementary gross income taxes may be introduced for a variety of reasons, such as:

- To avoid having to make a distinction between deductible interest for business expenses and non-deductible (or limited deductible) expenses for interest for house purchase or consumer credit. The taxpayer may find it easy to camouflage it as a business expense
- To reduce the tax advantage of borrowing compared with savings.
- To prevent arbitrage through taking out of loans with the main purpose of obtaining deduction of interest on such loans from income subject to tax
- To ensure high income groups pay a reasonable amount of tax and to counter tax avoidance.

Such provisions complicate the tax system and on the tax policy agenda are the relative advantages and disadvantages of the alternative approach of achieving similar objectives by further limiting the deductibility of interest payments from income subject to tax. In practice, the politicians seem to be less resistant to imposing such complicated schemes as alternative minimum or supplementary gross taxes, than to cutting back on interest deductibility.

Dual Income Taxes

Dual income taxes have been pioneered in the Nordic countries. Their objective is to ensure tax neutrality between different sources of finance and towards the taxation of retained and distributed profits and towards corporations and unincorporated firms.

Under a pure dual income tax a capital income is taxed at the same flat rate as corporate income and at (around) the lowest marginal rate applied to earned income. A pure DIT exists only in Norway; Sweden has a modified dual income tax. The advantages and defects of dual income tax are currently a live topic of debate.

The virtues consist in achieving such a balance, so that business decisions are not affected by the necessity of taking discriminatory taxation into account, and applying a comparatively low tax rate on personal savings so that they are discouraged from moving abroad to lower taxation.

The defects are of four kinds.

- It may be politically unacceptable to tax capital income at lower rate than earned income. For this reason Denmark virtually abandoned dual income tax and Sweden has a modified DIT.
- The distinction between capital and earned income is not always clear and the differential rates have been exploited for tax planning purposes.
- Close controlled unincorporated enterprises with large profits can take advantage of DIT to obtain a much lower PIT rate.
- Dual income tax systems typically have liberal rules allowing deduction of interest payments on personal debts. These can cause substantial revenue losses if taxpayers are able to borrow money to invest in tax-sheltered investments.

Presumptive Taxation of Capital Income

As a consequence of increasing cross-border capital mobility, there has been a prospect of leakage of tax revenues. Governments` reactions in different countries have varied according to this matter. The Netherlands introduced a tax reform in 2001 under which nearly all capital income actually earned (interest, dividend and rents) is totally exempt from PIT. Profits from unincorporated enterprises, labour income, imputed rent of home owners, pension income, and social benefits remain taxed at progressive rates. To avoid double taxation, net wealth invested in unincorporated enterprises and the first home is excluded from the taxable base of the presumptive income tax on net wealth.

The Tax Threshold

The tax threshold (the level of earnings at which income tax is first paid) is an important tax policy issue from a number of perspectives. First, it determines progressivity of an income tax system. Second, the size of the tax threshold may influence the point at which the poverty trap becomes operative. Third, the tax threshold will have an impact on the revenue yield from the PIT and increasing the threshold is generally costly in terms of revenue foregone.

One opinion about the income tax threshold is that, those around subsistence level should be not expected to pay income tax. This approach is adopted by France and Norway. At the other extreme is the view that for reasons of accountability or solidarity nearly all citizens should be expected to pay tax, even if at the lower end of the income scale the taxpayer may be a net beneficiary of the tax transfer system (e.g. Denmark, Sweden). In favour of high thresholds, it can also be argued that they reduce the poverty and unemployment traps. A main argument against this thresholds is the important amount of revenue thereby foregone, which may require what on other grounds may be seen as excessively progressive rate schedules and the introduction of an unprogressive PIT on gross income.

It would be misleading to look at particular countries` income tax thresholds without regard to their thresholds for social security contributions and even more misleading for the purposes of international comparisons.

3.3.3. Taxes on Labour

In the present context, we will consider both PIT and social security contributions to be taxes on labour. The employee's contribution is evidently a burden on the worker, unless the levy is shifted on to employers insofar as compensating wage demands are met. Employers` contributions may seem less evidently a tax on labour, but it is generally believed that over time both employee and employer contributions are shifted on to workers in the form of lower wages or, probably to a lesser extent, of higher consumer prices. A very different picture of workers` tax burdens emerges, when social security contributions are taken into account. Because of the following differences from PIT, contributions are typically an unprogressive form of taxation:

- No account is taken of family circumstances,
- a tax base nearer to gross wages than taxable income,

- unprogressive rates and a ceiling above which contributions are not payable, and,
- a very low tax threshold or even none at all.

High PIT revenues are in most countries accompanied by low social security contributions and conversely. The countries, where PIT predominates, are for example Canada, Sweden, the United Kingdom and the United States. Contributions outweigh PIT in France, Germany, Italy, Japan, the Netherlands, and Spain. Australia imposes no social security contributions.

Tab. 4 shows how the tax situation changes in different family circumstances, when different factors are included in the concept of taxation. Focusing on the tax system of ten OECD countries, the table shows average effective tax rates and the tax wedge, for eight family types, characterized by different family status, economic status and wage level. Wage levels represent 33, 67, 100 and 167 per cent of annual gross wage earnings of an average production worker (APW) in each of these countries. In the Tab. 4, is shown average effective rate of PIT (personal income tax due as a percentage of gross wage earnings). This underlines how progressive PIT generally is. It takes a higher share from families with higher incomes and makes allowances for children and single parents. For single workers without children at the wage level of APW (column 2) the average PIT rate varies between 6 per cent (Japan) and 26 per cent (Sweden). In most OECD countries, at the APW wage level, the average PIT rate of single persons is substantially higher than that faced by one-earner married couples with two young children (compare columns 2 and 5 of the Tab. 4). There are two exceptions here, Australia and Sweden. They impose the same rate of tax on one earner married couples and single persons if wages are the same. For the comparison, to see, how the effective tax rate of PIT changed between 2000 and 2004, we may observe data in the last two rows. We see that no radical changes occurred since 2004.

In Germany, United Kingdom and the United States, lone parents with two children at 67 per cent of APW wage receive a transfer payment through the PIT system which exceeds the amount of income tax due. Such non-wastable tax credits explain why column 4 of Tab. 4 shows a negative tax burden in these cases. In Germany, on balance even married workers with two children are entitled to a small payment from the government. A comparison of columns 5 and 6 in Tab. 4 demonstrates that if the spouse finds a job which pays her one-third of the APW wage, the PIT rate of the family will slightly increase in Germany, Japan, Netherlands, Spain and the United States. On the other hand, the PIT burden is not affected in France and the United Kingdom, and it falls in Australia, Italy and Sweden.

Tab. 4 Effective rate of personal income tax, 2000[21]

	Family type									
Status [a]	S	S	S	S	M	M	M	M	S[c]	M[c]
Number of children	0	0	0	2	2	2	2	0	0	2
Wage level [b]	0,67	1	1,67	0,67	1+0	1+0,33	1+0,67	1+0,33	1	1+0
Country										
Australia	18	23	30	17	23	19	21	19	24	24
France	9	13	18	8	8	8	9	10	13	7
Germany	15	21	30	-6	-1	7	12	15	20	-3
Italy	15	19	25	9	15	14	16	15	19	12
Japan	5	6	10	2	2	4	4	5	6	3
Netherlands	5	8	22	2	5	6	7	6	9	8
Spain	6	12	17	0	3	7	7	9	13	4
Sweden	24	26	34	24	26	25	25	25	24	24
United Kingdom	13	16	18	-10	13	13	15	13	16	8
United States	16	18	24	-6	8	11	13	16	17	2

[a] S = single, M = married couple
[b] Wage levels are in multiples of the average production worker's (APW) wage.
[c] Data (2004),
Source: OECD (2005)

Tab. 5 shows the effect of adding employees\` social security contributions, where the progressivity of PIT is reduced. First, average rates for Australia in Tab. 4 and Tab. 5 are the same, because Australia does not levy social security contributions.

For single workers without children at the wage level of an APW, the combined average rate of PIT plus employee contributions varies between 16 per cent (Japan) and 42 per cent (Germany). See column 2 of the table. Social security contributions are usually levied at the flat rate without any exempt threshold. In a number of countries ceiling applies. However, it usually comes into force at earnings levels exceeding 167 per cent of the APW wage. This particular rate

[21] as percentage of gross wage

structure is reflected in almost constant average contributions rate over the whole range of 33 per cent to 167 per cent of wage earnings. The combined PIT and contributions rate of single persons and married couples (in percentage points) is more or less similar to the margin between their average PIT rates.

We should next consider, the combined burden of PIT and employee social security contributions, but with levies due reduced by the amount of universal cash benefits that each family type is entitled to. Such transfers generally help families with children and lone partners, especially when they are on low incomes. Thus, figures, which present average rates of taxpayers without children, would be identical. Furthermore, Germany, Japan, Spain and the United States do not use universal cash transfers outside the tax system to provide financial assistance to parents, so their tax rates would be also identical with those in Tab. 5. In the countries that do use cash benefits, such transfers payments reduce the PIT plus contribution rate for average production workers by 6 points (France and Netherlands) to 9 percentage points (Australia, Italy and Sweden).[22]

We may also add employers` social security contributions to obtain an overall picture of the effect of the tax system and family benefits. Total levies due minus transfers received can be expressed as a percentage of total labour costs, which is gross wage plus employers` social security contributions. The latter are sometimes called non-wage labour costs. The gap between total labour costs and net take-home pay is also known as the wedge.

Many countries with high rate of PIT plus employee contributions tend to levy employers` contributions at relatively low rates, and conversely. In the case of the single worker at the APW wage level the wedge ranges from 23 to 24 percent of labour costs (Australia and Japan) to 50-52 per cent (Germany and Sweden).[23]

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[22] Data OECD: (2002b)

[23] Data OECD: (2002b)

Tab. 5 Effective rate of employee taxes, 2000[24]

	Family type							
Status [a]	S	S	S	S	M	M	M	M
Number of children	0	0	0	2	2	2	2	0
Wage level [b]	0,67	1	1,67	0,67	1+0	1+0,33	1+0,67	1+0,33
Country								
Australia	18	23	30	17	23	19	21	19
France	22	27	31	21	21	21	23	23
Germany	36	42	49	15	20	27	33	36
Italy	24	29	34	18	24	23	25	24
Japan	15	16	20	12	12	14	14	15
Netherlands	31	36	39	20	31	32	34	32
Spain	12	18	23	6	9	14	14	15
Sweden	31	33	39	31	33	32	32	32
United Kingdom	19	24	26	-3	21	19	22	19
United States	24	26	32	2	15	19	21	24

[a] S = single, M = married couple

[b] Wage levels are in multiples of the average production worker's (APW) wage.

Source: OECD (2002b)

3.4. *Family taxation*

A basic question in any income tax system is what should be the relative treatment of taxpayers in different working and family situations. There is a distinction between ends and means. Governments have varying conflicting ends such as to remain neutral or to encourage couples to get married, to influence their single or joint participation in the labour force, to determine what would be the most equitable, economically efficient and popular distribution of the tax burden between single persons, one-earner married couples and two-earner married couples. Neutrality towards these decisions at one income level may cause non-neutrality at other income levels. To achieve the preferred differentiation, governments have a variety of their means, e.g.: earned income of couples may be aggregated for tax purposes or each member of the couple may be taxed separately; reliefs may be progressive. The discussion related to means of instruments focused mostly on the choice of tax unit that has changed in most OECD countries over the

[24] as percentage of gross wage

last three decades from compulsory joint or family aggregation of income to separate taxation of couples or the option of separate taxation.

Choice of tax unit has relatively little importance for the relative tax burdens of different categories of taxpayers. In general, separate taxation favours high income two-earner couples and penalizes low-income two-earner couples. On other hand the rate schedule and the relief structure play a more important part in such determination. Choice of tax unit may have a relatively small influence on relative tax bills of different categories of taxpayers. However, it has a great deal of social significance in other respects. For instance, aggregated taxation is incompatible with the privacy of each spouse.[25]

It is up to the governments to decide what should be the relationship between the taxes paid by single and married taxpayers with the same level of pre-tax income. Today, it becomes increasingly accepted that men and women have a right to be considered as independent persons vis-à-vis the fiscal authorities and from other legal and socioeconomic points of view as well. Therefore, individuals should not be forced to adopt any particular attitude towards their habits of earning and spending even if, in practice, they may approach to them in the same way.

There is a view that married couples enjoy certain advantages in spending their income compared with single persons and newer approach that sees a need for marriage to be fiscally neutral in the sense that two earners pay more tax after marriage than before, or than two single partners with the same combined income. The comparison of taxes paid by single persons and married couples is closely related to the further question. What should be the tax paid by two single persons in gainful employment, if they marry and continue to work? If before and after marriage, there is no tax advantage or disadvantage between the positions of the two taxpayers, in this sense, the tax system is neutral. Such neutrality can be seen as desirable to avoid different influencing attitudes towards marriage and divorce. On the other hand, it may be considered desirable to make it more advantageous to marry from the tax point of view.[26] A reduction in the tax progressivity of the income tax system may be required to fulfill the objective of tax neutrality with respect to marriage. Especially in such case, when tax progressivity produces an

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[25] in practice almost always the wife

[26] no matter if one income earner or two are concerned

unequal treatment of taxpayers in different personal circumstances, but with the same income. It may be difficult simultaneously to achieve tax neutrality with regard to the decision to marry of two single persons, only one of whom is working, and of two persons, both in employment and who wish to continue working after marriage. Another problem is that a progressive income tax paid by a couple cannot satisfy the two criteria. First, that the income tax paid by a couple should be based on total income, regardless of how much each contributes. Second, that the total amount of tax paid by two persons should not change in the event of their getting married or divorced.

Taxation is believed to reduce labour supply of working wives more than other categories of taxpayers. There is not a general opinion as to what would constitute equal tax treatment for working wives. Many considerations in this sense are relevant, such as: the notions of discretionary income and of economies of scale when two people live together, of additional expenses associated with working, of the imputed income of wives who do not work outside the home, and so on. We may compare tax/benefit situation of working wives to her husband's situation, the single gainfully employed women, or of a wife not in the labour force. Relative tax treatment of a working wife compared to other categories will vary not only according to income level but also to whether her choice is to enter the labour force, remain in the labour force after marriage, work overtime or re-enter the labour force. The tax treatment of her additional costs, especially of child care, will be a main factor.

State subsidized child-care facilities or cash transfers to mothers reduce such expenses in many countries. Since most governments allow taxpayers to deduct from income subject to tax unavoidable costs directly incurred in earning income, it could be argued that child care expenses are an unavoidable cost of working for married women with children. On the other hand, it has been argued that such costs are also incurred by the wife who stays at home, where there take the form of an opportunity cost which is expressed in terms of a loss of leisure rather than an explicit money payment. The question is whether or not should the income tax system take account of the cost of bringing up children, and whether any such relief should apply equally to one and two-earner families.

According to Messere (2003) there are four normative positions towards the relationship between the tax/benefit system and the treatment of parents. Nowadays, first two of them are of less importance:

1. The Elitist Approach

This approach says that government should encourage the rich to procreate since the cost to society is less than costs of rearing the children by this family.

2. The Children as a Consumption Good Approach

This view considers children to be a form of consumption good, which couples choose to derive pleasure from. In OECD countries, where the means to avoid reproduction have been widely available, there is no reason for preferential treatment for parents unless governments wish to encourage this form of consumption.

The following two approaches are more important:

3.4.1. The Taxable Capacity Approach

The taxable capacity approach emphasizes the need to maintain horizontal equity under income tax systems[27] and we may summarize it as follows. Under income tax systems based on the principle of ability to pay[28], the taxable capacity of parents is considered to be lower than that of childless couples. It is so because of the additional expenditure needs connected with having children. The advocates of this approach argue that tax allowances are worth more to taxpayers with higher incomes than to taxpayers with lower incomes. And that it is merely due to the progressivity of tax systems.

According to this approach, what is relevant, is the appropriate differentiation between taxpayers having different sized families at given income levels. And the issue is not one of how taxpayers at different income levels should be treated. Proponents of the taxable capacity approach are concerned with the logic of a progressive income tax system based on the ability-to-pay principle.

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[27] It is closely discussed by Musgrave (1959) and defended, for example, by Brennan and Morss (1973)

[28] The widely held view that the amount of taxes someone pays should increase as their income increases.

They accept the need for cash transfers to parents with below subsistence income, but argue that this should not be done through the income tax system.

3.4.2. The Social Welfare Approach

The social welfare approach is more connected with alleviation of poverty. Poverty tends to be positively correlated with the number of children, rather than with horizontal equity. Its proponents consider that the main rationale for subsidizing parents is their need for such aid. Under this approach there is no place for tax allowances which benefit rich parents more than poor[29]. Under such an approach the appropriate method of aiding parents is either by cash transfers or by non-wastable tax credits[30].

Supporters of the taxable capacity approach refer that if the fixed amount were equal to that needed to support a child of a taxpayer in the lowest income bracket; its value (being equal to that amount multiplied by the lowest marginal rate of tax[31]) would be insufficient to compensate a higher-income parent. This parent would require relief equal to the subsistence costs multiplied by his marginal rate of tax. And vice versa, if the tax credit were sufficient to free the highest rate taxpayers from tax on the subsistence costs of their children, the reduction in tax liability would be too great for low-income parents. In other words, to provide a tax credit of the lower amount would, under the taxable capacity approach, be held to penalize rich parents unduly in relation to rich childless couples. And to grant a tax credit of the higher amount would be held to favour poor parents unduly in relation to poor childless couples.

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[29] or even wastable tax credits which are of no use to people, whose income is below the income tax threshold

[30] Refundable or non-wastable tax credits can reduce the tax owed below zero. It can result in a net payment to the taxpayer beyond their own payments into the tax system. It appears to be a moderate form of negative income tax. Examples: the *earned income tax credit* and *the additional child tax credit* in the US, and the *working tax credits* or *child tax credits* in the UK.

[31] The marginal tax rate refers to the increase in one's tax obligation as one's taxable income rises: marginal tax rate = Δ(tax obligation)/Δ(taxable income)

Supporters of the social welfare approach also oppose tax credits; that they are not going far enough to meet their objectives. Except for the fact that tax credits for parents which exceed tax liabilities are frequently wastable, credits are received usually by the father and cash transfers usually by the mother[32]. Also, cash transfers are in some countries taxable which meets progressivity objectives.

On a taxable capacity approach, it may be seen as perfectly normal that tax allowances exist side-by-side with cash transfers, and many governments operate aid to parents simultaneously through the two systems. However, a number of governments over the last twenty years have decided to aid parents exclusively outside the tax system.

Government choices on how to aid parents may be in practice more influenced by other considerations (practical and pragmatic) than by the philosophical attitudes. Three of these considerations are:

1. The general advantages and disadvantages influencing the choice between tax expenditures and direct expenditures concerning transparency, effects on total tax ratios, and so on.
2. The fact that usually, the father benefits most or entirely from tax reliefs and the mother from cash transfers. A move from tax reliefs to cash transfers will usually reduce the take-home pay of the husband. Although the disposable income of the family may be more or less unchanged. This move may lead to an increase in wage demands of the husband to compensate for the heavier tax burden (tax-push inflation). Conversely, a move from cash transfers to tax reliefs may be resisted by the wife without paid employment.[33]
3. Administrative convenience. It would seem that some countries have found tax reliefs, others cash transfers more convenient (and certain countries have changed their minds over the years).

3.5. Taxes on Labour and Work Supply

There are two main issues. First, at lower income levels the combination of income tax, social security contributions, and income-related benefits can create

[32] who needs them most

[33] Family allowances may be the only source of income over which she has control.

unemployment and poverty traps which discourage taxpayers from working more or even taking employment. The second is that tax may have a negative effect on the labour supply of married women. Many reforms to tax systems take as their objective to reduce such disincentives.

We may all agree that different types of taxpayers[34] are likely to respond in different ways to tax changes. This is not only a question of hours worked, but includes readiness to change work location, age of retirement and the form work takes, especially participation in the underground economy. Finally, a number of changes in income tax provisions, which were taken primarily for other reasons (such as horizontal equity or sex equality), could have effects on work supply.

Taxation is not the only (and probably not the most important) factor affecting work supply. There are more such factors effecting labour supply of people in different (family, economical, different age, etc.) status. As one example it can serve the following. The decisions of married women to enter the labour force are probably influenced more by the availability of cheap child-care facilities and cultural attitudes than provisions in the tax legislation. In spite of it, governments have attributed many tax changes over the last three decades to a wish to improve work incentives.

It could be helpful to look separately at the decisions that workers take over their hours from the decision whether or not to work. The effect of PIT on hours of work can be divided into the effect of the marginal tax rate on the substitution of leisure for work (the substitution effect) and the effect of the average tax rate in inducing more work to compensate for lost income (the income effect). Thus, any attempt to reduce the poverty trap[35] should involve the reduction in the marginal tax rate and/or an increase in the average tax rate. The emphasis has been on reducing marginal tax rates, because any attempt to increase the average tax rate at low-income levels is likely to worsen poverty.

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[34] the rich and poor, young workers and the elderly, primary and secondary earners of a family, part-time and full-time workers and overtime earners

[35] The welfare trap is a name for a situation in which taxation and welfare systems create strong incentives for people to stay on social welfare payments. This is also known as the unemployment trap or poverty trap in the UK.

A similar analysis can be applied to the work supply of married women. A number of countries have moved towards separate taxation of husband and wife (mainly in the interests of sex equality). However, advocates[36] of these changes have also argued that separate taxation allows married women to have their own tax schedule. Therefore, they usually face lower marginal tax rates than if they were taxed at their husbands` marginal rates under joint taxation. The loss of marriage relief that has often accompanied moves to separate taxation may entail a greater tax bill for low-paid two-earner couples than was previously the case under joint taxation. Taxation may produce a substitution effect that encourages married women's labour supply. Nevertheless, the income effect should not be neglected, and this depends on the exact way in which separate taxation has been introduced. If it has been designed to leave the average married couple paying the same amount of tax as before, a significant income effect is unlikely. On the other hand, if it were designed to reduce the taxation of married couples (eliminating the marriage penalty) the income effect could discourage married women's labour supply, and leave the overall effect uncertain.

We may also analyze the decision whether to work at all, in terms of the income and substitution effects. In this case, the substitution effect does not depend on the marginal tax rate but the average tax rate (including loss of social benefits) that would apply to the earned income. This distinction is important in a number of countries that have introduced tax provisions, usually in the form of non-wastable tax credits, to encourage participation in work. These tax credits are available to low income workers but they are withdrawn gradually with an increase in income. These provisions reduce the average tax rate on earned income so they encourage participation in work. But they also increase the marginal tax rate over the income range where the credits are withdrawn. This second effect (combined with the income effect of receiving the tax credit) reduces the hours of work of those workers who were already working and earning an income in the withdrawal range. Net effect on work supply of these tax credits depends on whether the work performed by people who join the labour force outweighs the reduced work of those already in the labour force. Because of this uncertain outcome, several governments regard the reduction of dependency that is involved in moving people into work as

[36] see, for example Apps, P. (1991) or Florence Jaumotte (2003)

an important social goal. This goal outweighs the possible reduction in hours of people who are already independent of the benefit system.

It is impossible to predict, a priori, in what circumstances the income effect will prevail over the substitution effect, and conversely.

There are some opinions, that lower taxes on labour increase the employment of primary earners, and others advocate the contrary view.[37] There now seems to be a consensus that tax/benefit incentives targeted at secondary earners are likely to increase their work supply if already in employment (or to seek employment in the formal economy, if unemployed). The predominance of the income effect over the substitution effect for secondary earners seems to apply irrespective of their income levels.

The effect of taxation on the work supply of high-income groups has attracted relatively little attention among those interested in tax policy. The heavy reduction in top PIT rates was not so much due to the adverse effect on work effort. It was a measure to prevent transfers of income to tax haven countries. Possibly also, Governments have also understood that high tax rates might inhibit risk-taking and innovation. Thus they might have a negative affect on the quality of labour supply. It is generally believed that the brain drain from Europe to the United States is due to differences in gross salaries (and greater research opportunities) and not to tax differentials. On the other hand, highly paid artists and athletes often use the option to reside in a so called tax heaven.

4. Tax Choices of OECD Countries

This chapter aims at identifying similarities and differences between the main choices of the OECD countries, with regard to tax levels, structures and systems-in many cases over the last forty or fifty years[38]. The chapter also tries to pick up some choices made by particular countries, not to be found elsewhere.

To cover nineteen countries in about as many pages can produce only a very superficial view of their tax system as a whole. Omitted from the thirty OECD

[37] those are mostly the countries with the high PIT and social security contributions

[38] for rather shorter periods for the newly joined members of OECD in the transitional economies

countries, are eleven countries (Australia, New Zealand, Belgium, Finland, France, Iceland, Korea, Luxembourg, Mexico Switzerland and Turkey).[39] Some of them have much in common with the Northern Europe group, with the economies in transition, with the central European group, and with USA, Canada and Japan.

It is rational to divide this survey largely by geographical regions. Between most of Europe and industrialized OECD non-Europe there has been a wide difference of the role of government, which has accelerated over the last three decades. European countries[40] have been much closer to the question of welfare state and this is shown most clearly in differences in their total tax ratios. Fifty years ago there was some correlation between total tax revenues (TTRs) levels and GDP per capita. This is now far from the case, when relatively poor countries like Greece and Portugal have a higher TTR than Japan and the United States. Another major difference between OECD Europe and industrialized OECD non-Europe is the tax structure. Consumption taxes and social security contributions are much more important for the most part of the Europe. To a much greater extent, non-Europe relies on different revenue sources, personal income taxes (PITs) and taxes on real estate. Of course there are many exceptions, and the OECD developing countries (Mexico and Turkey), rely mostly on consumption taxes.

There is also a rationale for treating OECD Europe and industrialized OECD nonEurope by geographical regions. Tax choices of Canada are influenced by those made in the United States. Within Europe there should be major convergences in tax choices between the Protestant countries of the north and the Catholic countries of the south. The tax systems of Austria and Germany and Ireland and the United Kingdom with their common language and history also have much in common, as have the OECD ex-communist countries. Neighboring countries frequently (but it is not a rule), take different tax policy decisions.

More space is given to some countries or groups of countries than others. This reflects their activity in tax reform rather than their economic importance. The survey begins with four relatively small Northern European countries. This is because:

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[39] however some of them are briefly mentioned in other subchapters

[40] except Ireland and Switzerland

- various tax reform commissions in these countries have contributed greatly to the analysis of all current tax policy issues;
- in these four countries, tax reforms have been implemented more frequently and successfully than almost anywhere else;
- many of these reforms are typical of those in other countries;
- they illustrate most clearly the main finding of this survey: that neighbouring countries with similar outlooks may still take different tax policy decisions.

4.1. Europe

4.1.1. Four Northern European Countries

Tab. 6 compares the tax levels of the four countries from 1955 to 2000, in relation to an OECD average. We may see their ranking compared to other OECD countries, in the brackets.

This table shows that it is only between 1975 and 1990 that all four countries have generally had the highest TTRs among OECD countries. Sweden has been on the first place for most years since 1965, as a result of a large increase in its total tax revenues between 1955 and 1965, and sustained until the end of the century, and Denmark has held second place since 1985.

Tab. 6 Total tax ratios in four Northern European countries[41]

Country	1955	1965	1975	1985	1990	2000
Denmark	23 (12)	30 (9)	41 (4)	49 (2)	47 (2)	49 (2)
Netherlands	27 (8)	33 (4)	43 (2)	44 (5)	43 (4)	41 (9)
Norway	28 (5)	30 (10)	40 (5)	43 (6)	42 (7)	40 (10)
Sweden	25 (9)	35 (1)	43 (1)	50 (1)	56 (1)	54 (1)
OECD average	25	26	31	34	36	37

The figures in brackets represent the ranking order of the four countries among OECD countries (according to data availability and the increasing membership of OECD).
Source: OECD (1981, 2002a).

In Norway there has been little change in the TTR since 1975. The TTRs in 1975 and 2000 are almost identical although many fluctuations over this period.

The tax increases between 1955 and 1975 took very different forms in the four countries. In Denmark, we may see, between 1965 and 1971, the increase in

[41] as a percentage of GDP

TTR from 30 to 41 per cent. It is accounted for almost entirely by increases in the PIT, due to a change in the method of collecting the tax and not adjusting the tax schedule for inflation. Norway's TTR increase in the 1970s from 35 to 41 per cent came from a mixture of corporate income tax (CIT) and value-added tax (VAT). Most important for Norway's TTR was the discovery of North Sea oil which between 1975 and 1985 increased the CIT ratio from 1 to over 7 per cent of GDP while as a percentage of total tax receipts, CIT revenues increased from 3 to 17 per cent over the same period[42].

The Swedish route to increased taxation was through payroll taxes on employers, both earmarked for social security contributions and unearmarked. Increases in other revenue sources in Sweden have been relatively slight. Like Sweden, the increase in the Netherlands' TTR between 1965 and 1985 was almost entirely due to an increase in revenues from social security contributions, but unlike Sweden there were no unearmarked payroll taxes and again unlike Sweden contributions from employees as well as employers increased.

Tax structures

Tab. 7 shows the tax structures of the four Northern European countries. It indicates the ratios of the most important taxes to TTR for selected years and compared to an OECD average.

There is shown in Tab. 7, that the four countries collect the bulk of their revenues in very different ways. Denmark with its very low reliance on social security contributions and extreme reliance on the personal income tax departs most from an OECD average. Norway relies most on consumption taxes and least on PIT and with Sweden it is the reverse. The Netherlands relies mostly on social security taxes, especially on employees. In all four countries most employees' contributions are levied on an income tax rather than gross wages base.

[42] Messere (2003)

Tab. 7 The tax mix in four Northern European countries

Country	Income taxes						Social security contributions		
	PIT revenues			CIT revenues					
	1965	1980	2000	1965	1980	2000	1965	1980	2000
Denmark	41	52	53	5	3	5	5	2	5
Netherlands	28	26	15	8	13	10	31	38	39
Norway	40	28	26	4	13	15	21	22	23
Sweden	49	41	36	6	3	8	12	29	28
OECD average	26	31	26	9	8	10	18	22	25
	Consumption taxes						Property and capital taxes		
	General			Selective					
	1965	1980	2000	1965	1980	2000	1965	1980	2000
Denmark	9	22	20	29	13	11	8	6	3
Netherlands	12	16	17	15	7	9	4	4	5
Norway	22	18	20	18	16	13	3	2	2
Sweden	10	13	13	19	9	7	2	1	3
OECD average	12	14	18	24	16	12	8	5	5

SOURCE: OECD (1981, 2002a).

The Personal Income Tax

The three Scandinavian countries (and these countries alone apart from Austria and Finland) have adopted the dual or differentiated income tax (DIT) system discussed above, though Denmark largely and Sweden partly have abandoned the theoretical DIT and Norway seems likely to follow[43].

All four countries have followed the world-wide trend to reduce PIT rates and to widen the PIT base. Paradoxically, in view of the dominance of centre-left governments, in the Scandinavian countries the PIT system was probably less progressive than elsewhere in the OECD area. Until the recent tax reforms, there was unlimited deductibility of interest and restricted or non-taxation of capital gains. After tax reforms of the late 1980s and early 1990s things have changed. Since then, interest payments can be deducted only from capital income in Denmark and Sweden and only from ordinary tax in Norway. In Denmark there has been a further restriction in recent years on the deductibility of mortgage interest. In the

[43] Since the 1992 tax reform, the Norwegian tax system has been based on a two-tier structure. in which income tax is levied on two different concepts of income: *general income* and *personal income*. In this dual income tax system, capital income earned by personal tax payers is taxed as general income at a flat tax rate of 28 percent, whilst income derived from labour and pensions are taxed progressively as personal income (top rate 64,7 percent in 2004). Source: Norwegian Ministry of finance.

Netherlands, as from 2001 interest on loans will no longer be deductible, but other notably mortgage interest payments will remain so, although with some limitations.

There remain differences between the three Scandinavian countries` treatment of capital gains: it is integrated with the income tax in Norway and Sweden where rates were respectively 28 and 30 per cent[44] but not so in Denmark where the rate may vary between zero and 40 per cent. At death, capital gains are deferred in Denmark and Sweden but exempt in Norway, while capital gains on gifts are taxed in Denmark, exempt in Norway and deferred in Sweden. The Netherlands remains one of the few OECD countries with no tax on capital gains realized outside the area of a personal business.

Nowadays the tax treatment of the family is fairly similar in all four countries. In practice the individual is the tax unit, though Norway provides an option for family rather than individual taxation. Parents universally receive cash transfers in all four countries. They are not aided through the tax system, except in the Netherlands, where a tax credit for children was introduced in 2001. There is no tax relief for married[45] couples, except for a wastable tax credit for one-earner families in the Netherlands which in 2001 replaced a former tax allowance. Tax relief was given to qualifying couples by way of a separate schedule in Norway and a tax credit in Sweden, in the 1970s.

Different forms in the four countries, has also taken indexation for inflation of the PIT schedule and allowances. It never existed in Norway. In Denmark it existed between 1975 and 1983 and applied fully to both the tax schedule (central and local) and to tax allowances. In Sweden, it existed between 1979 and 1983 and applied only to the central income tax schedule. It was restored in 1990, when consumer prices increased by 10 per cent, and since 1994 there has been only partial indexation of the tax threshold. In the Netherlands indexation was applied both to the tax schedule and allowances after 1971, but in some years it was suspended or applied only partially. After 1994, both tax allowances and the tax schedule have been fully indexed.

In Sweden, the PIT is almost entirely a local tax and in Denmark local government PIT revenues account for over half of total PIT revenues. In Norway,

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[44] Source: Norwegian Ministry of finance and Fact Sheets on Sweden. Swedish Institute. 2001.

[45] or qualifying unmarried

local governments also receive over half of PIT revenues but they have no power to change the rates or base of PIT. In the Netherlands the PIT is entirely a central government tax.

PIT and Social Security Contributions

There is a distinction between integrated and non-integrated social security contributions with PIT. Integrated contributions are such, where an identical base and threshold is applied to contributions and PIT. Unintegrated contributions refer to cases where some other base is used, such as a variant of gross wages (Norway) or flat rates without a threshold (Denmark). There is in all the four countries partial integration between social security contributions and the personal income tax. However, their treatment of these contributions is very different. In Denmark, the integration is almost complete, apart from small amounts of employees` contributions for pensions and unemployment benefits which account for less than 3 per cent of total tax revenues (the employers` counterpart representing less than 1 per cent). In Sweden, the unintegrated part of employees` contributions currently represents around 5 per cent of total tax revenues while the employer`s share represents nearly a quarter. In Norway, the corresponding figures 7,5 per cent of total tax revenues for the unintegrated employees` share and around 10,76 per cent for the employers share[46]. In the Netherlands, as a result of the 1990 tax reform, the unintegrated employers` contributions were largely shifted to employees. As a consequence, their share fell from around 18 to 6 per cent. In 1990, most of the employee contributions were integrated with PIT, but there remain unintegrated employee contributions for unemployment and disability insurance. In integrating the PIT base and the base of most employees` contributions in the 1990 reform, the Netherlands transferred all the contributions that stood to be integrated from employers to employees, grossing up employees` wages by the same amount. Unlike the Scandinavian countries, the Netherlands have insisted on emphasizing the essential differences that remain between unearmarked PIT and the PIT earmarked for financing some of the social insurances.

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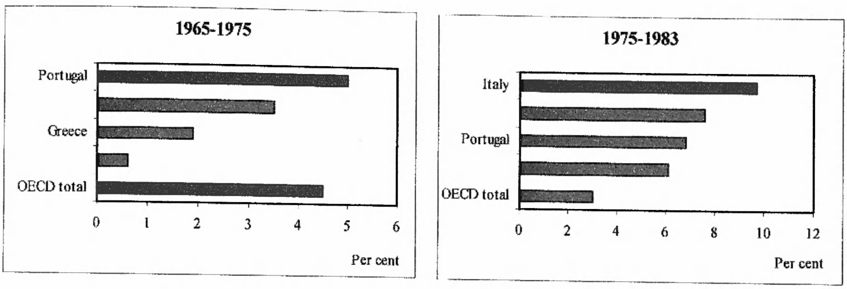
[46] Source: Ministry of Finance, Norway (and Account estimates, Revised National Budget 2006, May 2006.)

Of the total central government revenue, personal taxes on income and wealth, including employee's social security contributions, account, in Norway for about 21 per cent.

4.1.2. Four Southern European Countries

Between 1965 and 1980 three of these four countries (Greece, Portugal, and Spain) emerged from non-democratic regimes more or less at the same time, which is almost certainly the reason why their total tax ratios stagnated between 1965 and 1975 and followed the almost identical route of heavy increases between 1975 and 1983 (Fig. 4). These three countries had the lowest GDP per capita in Western Europe. It is thus understandable that they should have exhibited the lowest TTRs for most of this period.

Fig. 4 Changes in tax to GDP ratio[47]



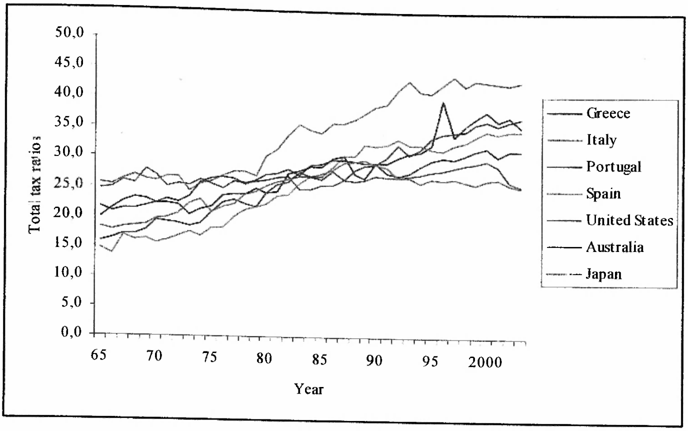
Source: OECD Revenue Statistics, own graph

But in choosing tax levels also political preferences play their part and by 1990 the TTR of these Southern European countries was more or less the same as the TTR of richer Australia, Japan, and United States and by 2000 it was much higher[48].

[47] in percentage points

[48] There is an interesting contrast with the more recent moves towards democratic regimes in South America, where TTRs did not immediately increase. It may be that while the welfare state was the role model for Greece, Portugal, and Spain, the low-tax United States was the role model for Latin America.

Fig. 5 Total tax revenues as percentage of GDP (1965-2003)

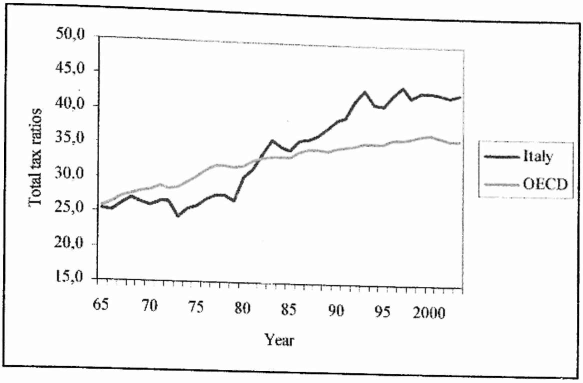


Source: OECD Revenue Statistics, own graph

The fourth country, Italy, has been in a different situation. His TTR has been more volatile than that of any European country. In 1965, its TTR was among the highest in the OECD, in 1975 among the lowest and in 2000 once again among the highest (see Fig. 6). This Italian volatility was influenced by many changes of government during the post-war period[49], variations in its large informal economy, major revisions of GDP, and improvements in the tax administration. But to which extend each of these changes have had impact on this volatility remains a matter for conjecture.

[49] more than fifty

Fig. 6 Total tax revenues as percentage of GDP (1965-2003)
Italy in comparison to OECD average



Source: OECD Revenue Statistics, own graph

In many respects the four countries share with France a Mediterranean climate where (Portugal excepted) cigarettes and alcohol are considered necessities to be taxed lightly and, given the large share of artisans and farmers in the working population, high PIT collection is an impossibility. The tax mix of the four countries is otherwise very different. Greece relies most on VAT and social security contributions and very unusually in Europe, largely on those of employees. Portugal relies to a greater extent on excises than any other OECD European country and in Italy and Spain (as in France) employers` social security contributions are the greatest revenue raisers. Following the tax reforms in 1970s in both Italy and Spain, there has been a move away from these contributions towards PIT but these contributions remain well above the OECD average.

These four countries have followed the overwhelming OECD trend since the mid1980s to reduce top PIT rates and flatten the schedule, but in contrast to the OECD trend, CIT rates in Italy, Portugal, and Spain have not fallen at all and in Greece only slightly. There is also little indication of broadening the income tax bases of these four countries-again in contrast to what has happened in most OECD countries. In Spain, for example, despite an income tax reform in 1998, which introduced greater neutrality, the tax system still encourages investment in housing and favours long holding periods for investment in life insurance and pension schemes. Still, there remain special regimes for unincorporated business and the self-employed. Similarly, attempts have been made in Italy to broaden the tax base by taxing capital gains more widely, but legislation has changed frequently.

The systems of corporate income taxes of these four countries have evolved in very different ways.

Portugal has had some form of shareholder relief for many years. Previously, Greece was the only country to have had zero corporation taxation of distributed profits whereas now it is zero taxation of dividends. Italy has had in principle an imputation system with full credit for many years, but it was not until 1997 that the link between tax credit and corporation tax paid was realized in practice. Spain has tried both a classical system and relief for distributed profits at the company level, but now has shareholder relief.

As well as being more industrialized than Greece or Portugal, Italy and especially Spain face greater pressures for fiscal decentralization. The share of local government revenues in TTR in both Italy and Spain has been increasing over the last twenty years.

Along with France, Spain has been the only OECD country to have recently introduced and retained a net wealth tax. But otherwise, with the exception of Italy, there has been little tax innovation in Southern Europe. In common with most countries with a low per capita income, the greatest constraint on tax reform is likely to be the capacity of the tax administration to implement it. Lasheros and Menendez (1998: 324) summary for Spain probably applies equally to Greece and Portugal:

> It is possible to maintain that the main focus of tax reforms during the coming years should be on tax administration. The need to modernize the administration and to adapt it to the changes that have occurred in recent years overshadows the need for other tax changes.

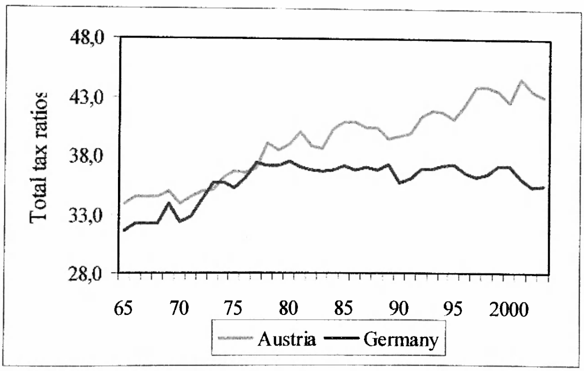
A similar view is expressed in Castellucci's (1998: 208-12) summary for Italy, where attention is drawn particularly to the low quality of the tax administration at the level of local government, which is considered to be a major constraint on giving local government greater taxing powers. Castellucci also finds that Italy's tax reforms evolved quite sensibly on the lines of those of other European countries from the basic tax reform of 1973-74 to the early 1990s. Subsequently, it has become quite difficult to identify any rationale behind the fragmented interventions. These were often disrupting what was built over many years, apart from getting more revenue in the short term.

More recently, Italy introduced a novel method of offsetting the tax incentive for corporations to finance investment through debt rather than equity.

4.1.3. Two Central European Countries

The tax profiles of Austria and Germany have much in common but there remain many differences between them, as with the foregoing groups of countries. A main shared feature is the relative stability in their tax levels and tax mix. It is true that from 1955 to 1985 Germany was a high-tax country relative to the rest of Europe, since when it has become an average European country. Even the 1990 unification of Germany did not greatly disturb the stability of the German TTR, which since 1973 has never been less than 35 per cent, never more than 39 per cent of GDP. The Austrian TTR has always during the post-war years been considerably higher than the German, but between 1984 and 2000 it remained almost unchanged, varying between 41 and 45 per cent (see Fig. 7).

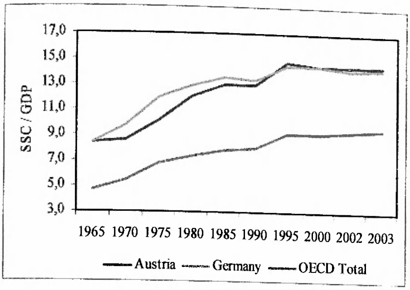
Fig. 7 Total tax revenues as percentage of GDP (1965-2003)
Austria and Germany

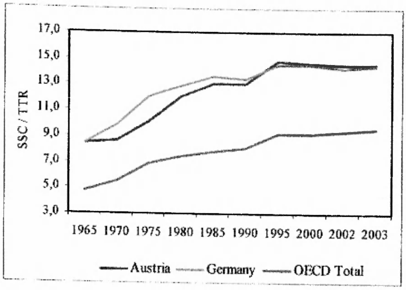


Source: OECD Revenue Statistics, own graph

The tax mix (see Tab. 11) in the two Central European countries has also remained stable. As in other countries reliance on social security contributions has increased-especially in Germany-and the share of selective consumption taxes decreased-especially in Austria. There is little difference between 1965 and 2000 in the two countries regarding the share of the other major revenue sources. As we may see in the Fig. 9, for example, the reliance on taxes on income and profits has not changed since 1965 significantly.

Fig. 8 Social security contributions as percentage of GDP and of total taxation in Austria and Germany (1965-2003)





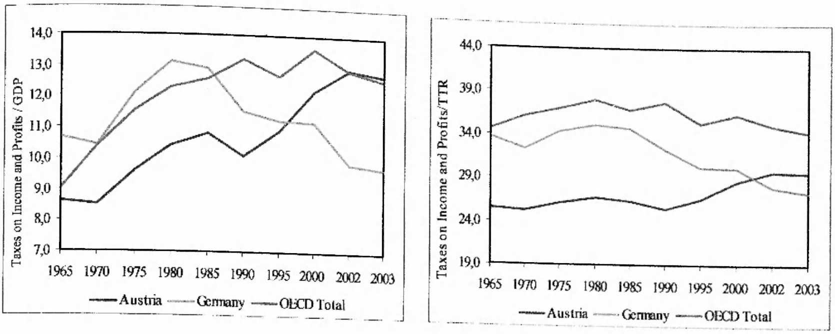
Source: OECD Revenue Statistics, own graph

„Austria and Germany have followed the general OECD trend regarding base widening and rate lowering of PIT and CIT, but their CIT systems have diverged. From 1920, when the German CIT first existed until 1953 when the split rate system was introduced (51 per cent on retained and 15 per cent on distributed profits), Germany had a classical system. In the mid-1970s, Germany followed the French route of an imputation system (with full credit instead of partial credit). From 2001, Germany abandoned both the split rate and imputation system in favour of dividend relief. On the other hand, Austria had a classical system until 1968 when a split rate system was introduced. In 1986 Austria added a shareholder relief provision and in 1989 abolished the split rate. Thus, as of 2001 Austria and Germany have similar systems, but have reached them via very different routes.“[50]

Fig. 9 shows the development of taxes on incomes and profits in Austria and Germany. In the first figure we may see taxes on income and profits as a percentage of GDP. Austria was (concerning taxes on income and profits as a percentage of GDP) placed close to OECD average, Germany little bit lower, in the 2003. And also their share of taxes on income and profits as a ratio of TTR remained quite stable in both countries, over this period.

[50] Messere 2003

Fig. 9 Taxes on income and profits as percentage of GDP and of total taxation in Austria and Germany (1965-2003)



Source: OECD Revenue Statistics 2005, own graphs[51]

The general consumption tax profiles of Austria and Germany are almost identical. Cascade taxes were introduced in Austria in 1923 and Germany in 1916 and were replaced by VAT in Austria in 1973 and Germany in 1968. In each case, it was with a standard rate for most goods and services and, a reduced rate for some. The fact that the Austrian standard rate is higher than the German standard rate is one reason why the Austrian TTR is higher (see Fig. 7).

Along with the group of Northern European countries discussed in Section 4.1.1 , and unlike other European countries, Austria and Germany had net wealth taxes dating back to the nineteenth century but these were abolished during the 1990s. Over the years, the proportion of the base allocated to income, capital, and payroll has varied and is very different between the two countries.

In contrast to the only other OECD European federal state (Switzerland), Austria and Germany both operate a tax sharing system negotiated between the federal government and the Länder, but in neither country do the Lander authorities have much say about the rates and base of the taxes which they share. A big contrast between the two countries is that while in Austria around half of TTR accrues to the federal government, in Germany the percentage is around 30 per cent-well below that of any OECD federal country except Switzerland.

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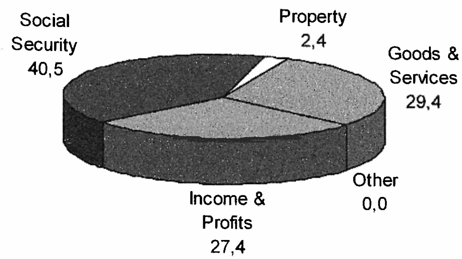
[51] From 1995, the total tax revenues have been reduced by the amount of capital transfer.

Since the 1970s successive Austrian governments have been particularly active in the field of business taxation, where there has been a search for tax neutrality between unincorporated and corporate enterprises and the differing forms of capital income. Outside the Nordic countries, Austria has been the only country so far to adopt the dual income tax described in Section 3.3.2.

A unique feature of the German system is the use of mathematical formulae to impart progressivity to the PIT system, instead of applying brackets where rates increase as income increases, as happens in every other OECD country. Another unusual feature of German tax system was the following. To help meet the costs of its unification, Germany imposed a one-year-only PIT surcharge in 1991 followed by an indefinite PIT surcharge in 1995. This did not much increase Germany`s TTR.

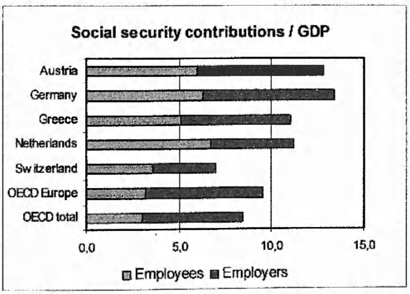
Fig. 10 Tax revenue of main headings as percentage of total taxation, Germany 2003

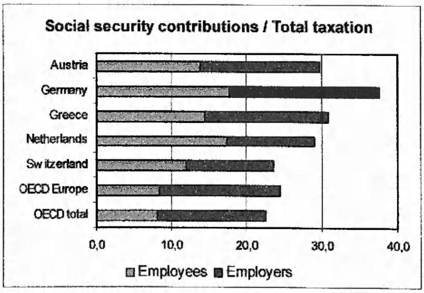


Source: OECD Revenue Statistics 2005, own graph

German tax mix does not differ greatly from an OECD average. The major exception is the heavy reliance on social security contributions, and whereas all such countries except Greece, the Netherlands, and Switzerland impose the bulk of the levy on employers, in Germany the distribution over employers and employees approaches 50/50. The consequence is that receipts from employees` contributions are higher as a percentage of GDP or TTR in Germany than in almost any other OECD country.

Fig. 11 Employees` and employers` social security contributions as percentage of GDP and of total taxation (2003).

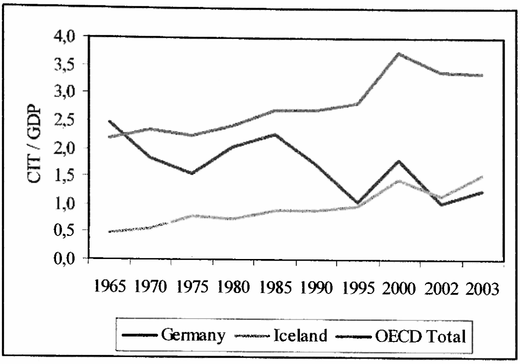




Source: OECD Revenue Statistics 2005, own graphs

Despite the high nominal rates of the German CIT (until the tax reform at the end of the century), its yield as a percentage of GDP is lower than that of any other OECD European country (except Iceland), largely because most enterprises choose not to be incorporated (the exact reverse of Japan, see subchapter 4.2.2 - Japan). It may well be due to the high rate on undistributed profits. Another reason for the low corporate income tax yield may be the erosion of the tax base.

Fig. 12 Corporate income tax as percentage of GDP, Germany



Source: OECD Revenue Statistics 2005, own graph

A major tax reform was enacted in July 2000. Among the changes were:

- a reduction in the basic rate of PIT from nearly 23 to 15 per cent;
- a cut in the top PIT rate from 51 to 42 per cent by 2005;
- a cut in the federal CIT rate from 52 to 39 per cent by 2005;
- abolition of imputation system and split rate with the replacement of some shareholder relief;
- abolition of capital gains tax on corporate shareholdings as well as on shares held by banks and other businesses.[52]

4.1.4. Two Western European Countries – Ireland, UK

We should treat United Kingdom and Ireland separately, but there are also some similarities between them, especially as regards the tax mix. United Kingdom

[52] MESSERE (2003)

influenced Ireland in many respects. Ireland has been under the British occupation during the first twenty-two years of the twentieth century.

A first similarity is that for most of the century, they have very heavy relied on customs and excise duties on cigarettes and alcoholic drinks. This reliance was reduced by the introduction of VAT, both in United Kingdom and Ireland, in 1973. As of 1955, selective consumption taxes accounted for nearly half of Irish TTR, well above any other OECD country. Currently they still account for a greater share of revenues than any other OECD country, except Portugal. In 1955 the British reliance on selective consumption taxes was also very high, but nowadays it is only slightly above the European average.

A second similarity is that, the British and Irish reliance on taxes on immovable property was far greater than that of any other European country until around 1975. The British share of revenues from property taxes remains much higher than in any other European country, but the Irish share is only slightly above the European average nowadays.

A third similarity in the tax mix of Ireland and the United Kingdom has been the low reliance on social security contributions throughout the post-war period. The share of revenues from contributions in Ireland has been lower than that of any other European country[53] and in the United Kingdom it has always been well below the OECD European average.

Another similarity between the two countries is that the share of tax revenues accruing to local government in each of them is among the lowest in Europe. Over the last fifty years it has been declining for most of the period. They are also two of the few countries where the TTR declined during the late 1980s and early 1990s.

The explanation for Ireland's extreme tax structure in the 1960s and most of the 1970s, apart from its low GDP per capita, was the high proportion of agriculture in the economy. Until the late 1970s, most farmers did not pay income tax, and, evidently, no social security contributions. The Irish tax system was gradually modernized during the 1970s and 1980s. The two most important changes were the introduction of VAT in 1973 and the spreading of the income tax net to

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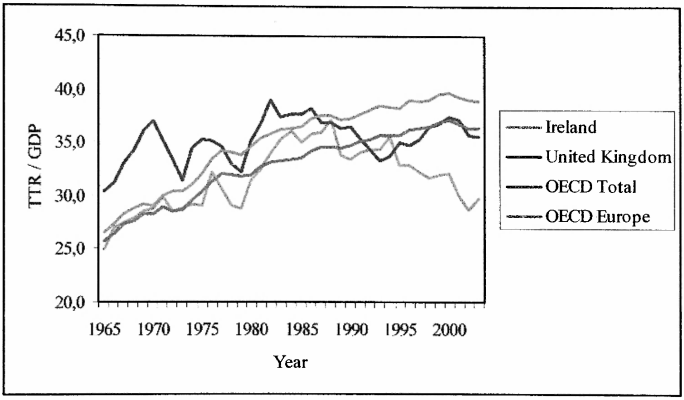
[53] Ireland is one of the few OECD countries where most social security benefits are financed by voluntary contributions to the private sector.

include most farmers during the late 1970s and early 1980s. In 1978 the property tax on households was abolished.

One consequence of the modernization of the Irish tax system (and tax administration) was that between 1965 and 1988 when it peaked, the Irish TTR increased from 25 per cent (just below the overall OECD average) to 39 per cent of GDP. Since then it has gradually declined to 31 per cent in 2000. Annual changes in the Irish TTR, as well as the various components of it, have been much more volatile than in most European countries. The decline in the Irish TTR during the 1990s is accounted for by a reduction in revenues from social security contributions and consumption taxes. Receipts from the income taxes remained unchanged despite low rates and various concessions for a number of categories of taxpayers.

Fig. 13 Total tax revenues as a percentage of GDP



Source: OECD Revenue Statistics 2005, own graph

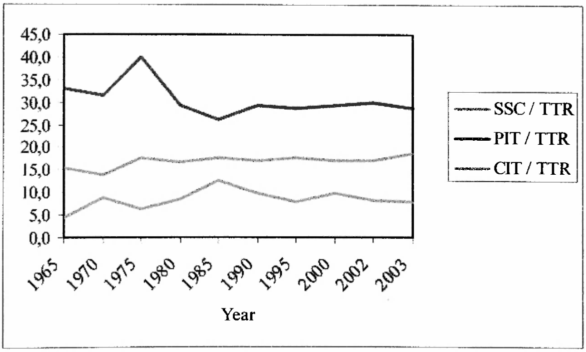
Ireland encouraged international tax competition to attract inward investment by offering income tax privileges to non-resident individuals and companies. It has been criticized (especially in the European Union) that these concessions represent unfair tax competition.

Ireland is currently the fastest-growing economy in the European Union. Over recent decades a predominantly agricultural society has been transferred to one of advanced technology. How far its competitive income tax policy has contributed to this transformation remains a matter for speculation.

The British total tax ratio movements have been volatile, as in the case of Ireland. The TTR reached a first peak in 1970 at 37 per cent of GDP. During most of the 1970s it fell and reached a trough in 1979 at 32 per cent. It then increased at the beginning of the Thatcher administration to reach its highest to date in 1982 at 39 per cent, a far greater decline than in any other OECD country over that period. In the following eleven years it decreased to 33 per cent in 1993. After 1993 the British TTR increased and reached 37 per cent in 2000 and 35,6 per cent in 2003.[54] After the year 1965, the United Kingdom has changed from being a high tax to a relatively low tax country by European standards, but to average in the OECD area as a whole (see Fig. 13).

Over the period 1965-2000, the UK tax mix has changed considerably. There has been a considerable drop in the share of PIT revenues. At the same time there has been a smaller increase in CIT revenues with the same trend as in other countries from selective to general consumption taxes. The United Kingdom was also in the vanguard of base-broadening and rate-reducing of the income taxes. These trends have later on spread to most OECD countries.

Fig. 14 PIT, CIT and SSC as percentage of total tax revenues UK (1965-2003)



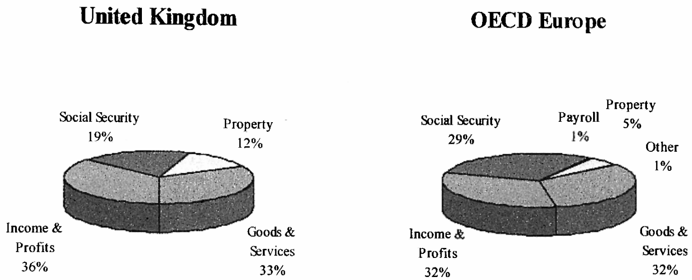
Source: OECD Revenue Statistics 2005, own graph

In the Fig. 14, we may see the development of the share of personal income tax, corporate income tax and social security contributions since 1965. Personal

[54] OECD Revenue Statistics 2005

income taxes were reduced by the structural reform of the end of the 1970s. There has been a sharp decrease of PIT especially between 1975 and 1985 from 40 per cent to 26 per cent of total tax revenues. In fact they decreased from 14 per cent of GDP in 1975 to 11 per cent in 1980, and then they remained stable at around 10,5 per cent until 2005. Social security contributions have been slightly increasing over the whole period. Indirect taxes show a stable pattern over a thirty-year period, varying between 14-15 per cent of GDP. [55]

Fig. 15 Tax revenue of main headings as percentage of total taxation, United Kingdom 2003



Source: OECD Revenue Statistics 2005, own graphs

The United Kingdom diverges from the rest of Europe in several respects with regard to value-added taxation and capital and property taxation (see Fig. 15)[56].

4.1.5. Transitional Economies

Czechoslovakia, Hungary, and Poland, along with Bulgaria, Romania, and Yugoslavia, adopted economic systems based on the Soviet model and also a similar tax system, during the period 1945-50. The main features of the tax system were:

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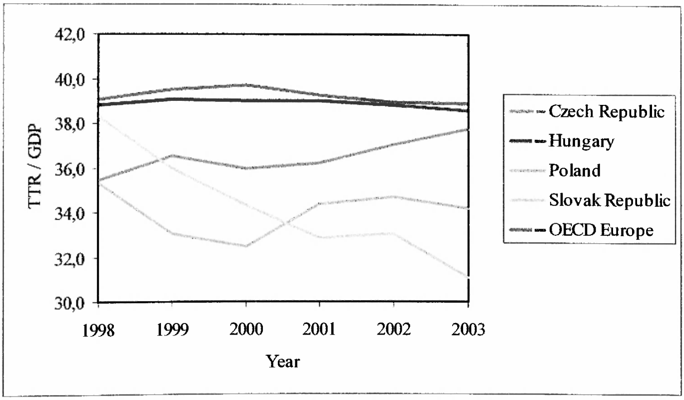
[55] BERNARDI et al. (2004)

[56] For a more detailed overview of the tax system of UK see MIGALI (2004)

- The total tax ratio was usually much higher than that of all OECD countries until the early 1990s. For example, in 1989 the TTR was 60 per cent in Czechoslovakia, 61 per cent in Hungary, and 40 per cent in Poland. [57]
- A very high proportion of tax revenues were collected from state enterprises (either by way of taxes on profits or of turnover taxes). The turnover tax was essentially a supplementary tax on the profits of the state enterprises, because most commodity prices were fixed by the state.
- Separate turnover tax rates were fixed for different kinds of product, some of which also received subsidies.

This section comments briefly subsequent developments in four transitional economies (members of the OECD), namely the Czech Republic, Hungary, Poland and Slovak Republic. At the start of the twenty-first century, under a typically OECD type tax system the Czech Republic and Hungary have a TTR of around 39 per cent, about an OECD European average, while the TTR of Poland at 34 per cent and Slovak Republic at 31 per cent are well below this average (see Fig. 16).

Fig. 16 Total tax revenues as a percentage of GDP
Four transition countries (1998-2003)

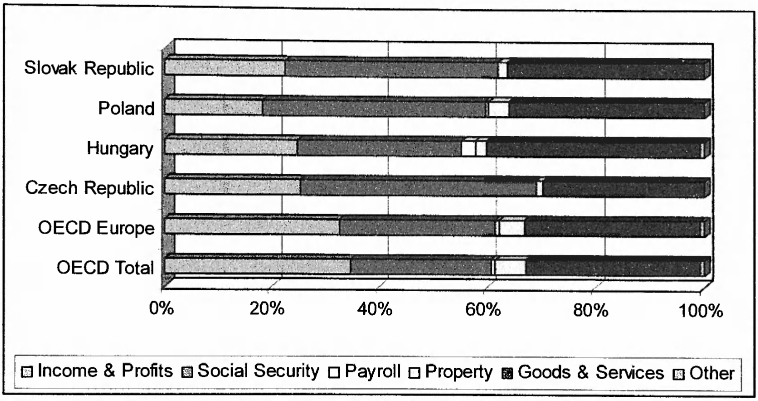


Source: OECD Revenue Statistics 2005, own graph

[57] For a much fuller summary see Chapter 2 of MARTINEZ - VASQUEZ and McNAB (1997).

The tax structures of the four countries differ. They all have a greater than average reliance on social security contributions but in the Czech Republic it is far higher than any other OECD country (43,6 per cent of TTR, compared to OECD average at 26,1 per cent in 2003), whereas Hungary has a greater reliance on consumption taxation than nearly all OECD countries (39,4 per cent of Total taxation in 2003). All four countries rely less than average on income taxes, Poland at 18 per cent and Slovak Republic at 22 per cent of TTR are well below the average of OECD in 2003.

Fig. 17 Tax revenue of main headings as percentage of total taxation, Transition countries 2003



Source: OECD Revenue Statistics 2005, own graph

There has been a complete overhaul of the systems of taxation in these four EU acceding countries during the last fifteen years. The opportunity of EU membership has had an impact on the process of tax reform in these countries. The goal was to harmonize their systems of public finance with those in the EU. It has been the most important catalyst of the reforms.

Introduction of the personal income tax and transformation of the enterprise taxes into profit (corporate income) taxes have been among the first (and most important) tax reforms. The system of turnover taxes was replaced by value-added tax (VAT) and excise taxes. The reorganization of the social security systems, pension and health care systems has been the most complex part of public finance reforms.

Countries have chosen different strategies of tax reforms. Probably the most radical reform is the one introduced in Slovakia in 2003.

Slovakia

„In 2004 the government implemented a fundamental tax reform which unified the rate structure of the tax system by setting the tax rates of the personal income tax (PIT), the corporate income tax (CIT) and the value added tax (VAT) all equal to 19%. Together with these changes in tax rates many exceptions, exemptions and special regimes were eliminated. This reform has made the tax system much simpler and more transparent and it is widely judged that its effect on the economy will be positive.“[58] This reform caused that, Slovakia became the first OECD country with a flat personal income tax.[59]

The government`s objectives for the tax reform were: "creation of a business and investment friendly environment for both individuals and companies; elimination of existing weaknesses and distortionary effects of the tax law; and achievement of a high degree of tax fairness by taxing all types and amounts of income equally".[60] Tax reform was designed to be revenue-neutral with the tax reductions in the personal income tax (PIT) and the corporate income tax (CIT) being compensated by increases in the VAT thus leading to a shift in the tax burden from income to consumption.[61]

Income Tax

Conception of tax reform 2004 - 2006 proposed introduction of flat tax system in the field of income tax. It means that all types of personal and corporate income are from the January 1, 2004 taxed by one linear tax rate of 19 per cent. This tax system has replaced PIT which had its progressive rate structure[62] with five income brackets with marginal tax rates of 10 per cent, 20 per cent, 28 per cent, 35 per cent, and 38 per cent.

According to MF SR (2005) this radical change has these major advantages:

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[58] BROOK and LEIBFRITZ (2005)

[59] Some other Central and Eastern European countries had introduced flat personal income tax before, the first countries were Estonia and Lithuania in 1994.

[60] MF SR (2005)

[61] BROOK and LEIBFRITZ (2005)

[62] after the basic exemptions

- The flat-rate tax still maintains the progressive nature of effective tax rates faced by individuals with different amounts of income. All personal income of up to 1,6 times the poverty line will be exempt from taxation.[63] Impact of introduction of flat tax on direct income will be non-negative on low-income earners, negligible in the medium range of income distribution and positive on people with the highest incomes.
- The existence of single marginal tax rate for all income above the standard exemption sharply decreases the distortive effect of personal income taxation. „This should increase labor productivity both in the short and long term, as it encourages higher work effort at any given point in time, as well more investment in human capital."[64]

Average and marginal personal tax rates declined for many workers. There was a replacement of income dependent child allowance with a universal child benefit. This has reduced marginal tax rates of workers with children. Reduction of the personal income tax makes it easier to comply with the tax code, and reduces the incentive to participate in the shadow economy. Total tax wedge on labour remains high because of high social security contributions. Incentives for seeking work have been strengthened by the reduction in social assistance levels. This high tax wedge with a minimum wage (that is high in relation to average wages), means that demand for labour is constrained, particularly at the lower end of the labour market.[65]

The corporate tax was reduced to 19% from the previous rate of 25%. According to new tax system, investment and capital gains income are taxed only once. Dividend taxation has been cancelled and investment income will be taxed only once, at the level of corporate profits.[66]

Slovakia had prior to tax reform a standard value added tax (VAT) rate of 20% and a reduced rate of 14%. Reduced VAT was cancelled entirely and a unified

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[63] The effective tax rate for individuals below this threshold will be null. However, the average tax rate will start increasing once the individual surpasses this threshold.

[64] MF SR (2005)

[65] OECD: Economic Surveys Slovak Republic (2005)

[66] MF SR (2005)

19% rate was introduced for all goods and services. Reduced VAT rates were supposed to lead toward the achievement of non-fiscal policy goals (generate lower prices, leading to better access by low income groups to basic food and other selected goods, or increased consumption of goods). There are doubts on whether reduced VAT rates truly support the fulfillment of such objectives in spite of the inefficiencies that they introduce. Slovak government decided to replace these inefficient fiscal policy instruments with targeted instruments directly in the relevant policy areas, such as social policy and health care.[67]

Tab. 8 Tax revenue of major taxes as a percentage of GDP, Slovakia.

% GDP	2002	2006[a]
Income tax	6,9	5,0
Personal income tax	3,4	2,4
Corporate income tax	2,7	2,2
Withholding income tax	0,9	0,4
Value-added tax	7,6	8,4
Excise taxes	3,1	3,2
Gift, inheritance, property transfer tax	0,2	0,0
Local taxes	0,6	0,7
Road tax	0,2	0,0
Other tax revenues	0,4	0,1
Total tax revenues	19,0	17,3

Source: MF SR (2004)

"The responses from companies and economists from Slovakia and abroad confirm that the fundamental tax reform concept created in the Slovak Republic one of the most competitive tax systems in the entire EU and OECD area."[68]

4.2. Industrialized OECD Non-Europe

4.2.1. Two North American Countries USA, Canada

The total tax ratio of Canada has not been far from the OECD average for most of the last forty years. Canada's reliance on income taxes and property taxes remains well above the OECD average. Its reliance on social security contributions and consumption taxes remains well below the average. There has been an increase

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[67] MF SR (2005)

[a] estimates of MF SR

[68] MF SR (2004)

in PIT and social security contributions and a decrease in the share of consumption taxes over the last twenty years. Canada's tax policy is to some extent constrained by what happens in the United States. The most obvious example was the imitation of the US 1986 Tax Reform that involved rate-lowering and base-widening of the income taxes. This was rapidly imitated by most other OECD countries. A more unusual example, which is perhaps unique[69] to Canada, is its reduction of tobacco duties in 1994. Tobacco duties of the United States were so much lower that extensive smuggling took place.

Canada and the United States have made different choices in many ways. As regards PIT faced by couples, the individual is the normal unit for Canada and the married couple for the United States. As regards CIT, Canada has opted for dividend relief and the United States for a classical system. But the most interesting and important difference is that Canada is the only OECD country to have a general consumption tax at both the federal and provincial levels. The United States is the only OECD country to lack a federal general consumption tax. These unique features of Canadian tax system are the result of the taxing powers of subnational governments, which are greater than those of any other OECD country.[70]

Canada has a bewildering mixture of general consumption taxes at the federal and provincial levels. Evidently, there is a cost in terms of revenue forgone, compliance and neutrality, but Canada has decided that provincial autonomy should be given precedence over these drawbacks. Over one-third of tax revenues are allocated to the provinces, a far greater share than in any other OECD federal country.[71]

Canada and the United States are the only OECD countries to have subsidized the poor for many years by way of non-wastable PIT credits. Nowadays a number of other countries do, but only in recent years.

The total tax ratio of the United States at 25 per cent of GDP was less than one percentage point below the OECD average, in 1965. In 1992, at 27 per cent, it was more then eight percentage points below that average. After 1992 the TTR

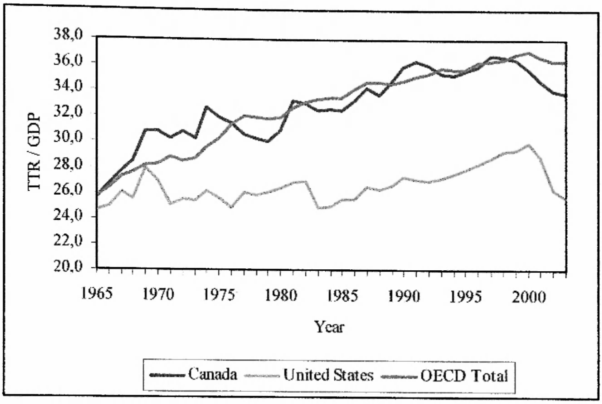
[69] Despite their great differentiation in rates of excise, high excise European countries have not found it necessary to reduce their rates because of cross-border shipping or smuggling.

[70] save perhaps in Denmark, Sweden, and Switzerland

[71] BIRD and GENDRON (2001)

increased more than in most countries due to a mixture of economic resurgence.[72] Total tax revenues peaked at almost 30 per cent in 2000 and decreased to 26 per cent in 2003. It remains, however, below that of countries such as Greece, Portugal, and Turkey.[73]

Fig. 18 Total tax revenues as percentage of GDP, Canada, USA



Source: OECD 2005, own graph

Between 1965 and 2003 income taxes were the most important source of United States revenues. There has been a considerable increase in PIT revenues from 1985 to 2000, and a decrease thereafter. And there was a corresponding decrease in CIT revenues, which declined from 4 per cent of GDP in year 1965 to 2 per cent in 2003. Revenues from social security contributions have increased considerably since 1965 and now approach the OECD average (6,7 per cent USA and 9,5 per cent OECD average in 2003).[74] Property taxes and consumption taxes have both declined over this period. However, whilst revenues from the property taxes still represent twice an OECD average, those from consumption taxes at around 16 per cent of total tax revenues are the very lowest in the OECD area. Most recently, the tax mix has been stable. A further increase of the share of social security revenues has been offset by decreases in that of CIT and consumption taxes.

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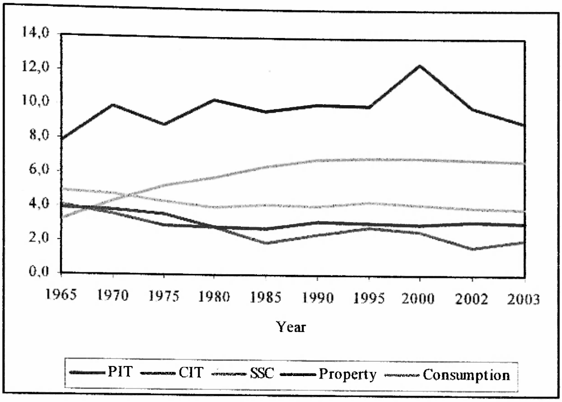
[72] MESSERE (1998)

[73] OECD (2005)

[74] OECD (2005)

Fig. 19 Tax revenue of main headings as percentage of GDP USA (1965-2003)



Source: OECD 2005, own graph

The states have the right to impose all the major taxes, except social security contributions, at their chosen and very divergent rates, most revenues coming from personal income tax and general consumption taxes, usually retail sales taxes. Residents of the states have the right to reduce their taxes by referendum.

The Tax Reform Act

The Tax Reform Act of 1986 was the most sweeping federal tax legislation since the Revenue Act of 1942. It converted the income tax from a tax applying to only a few taxpayers to a mass tax applying to the many. It dramatically lowered marginal tax rates. For individuals, it cut the top marginal tax rate from 50 to 28 per cent and for corporations; it reduced the top tax rate from 46 to 34 per cent. To achieve a revenue-neutral outcome in the face of reduced marginal tax rates, the 1986 Act significantly broadened the bases of the individual and corporate income taxes.

The Tax Reform Act of 1986 was revolutionary in the depth of the rate cuts, the extent of its base broadening, and the increase in business taxes. It also set the stage for the income tax legislation enacted since 1986.[75]

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[75] MESSERE (1998)

Despite the 1986 base-widening reform, the US PIT base remains narrower than in many other OECD countries. Concessions include tax deductions for mortgage interest on secondary homes, medical expenses, charitable donations and State taxes as well as a relatively generous treatment of fringe benefits, pensions and life insurance contributions. Also the rate-lowering and base-widening of PIT in 1986 was reversed during the 1990s.[76]

There are two unusual features of the United States` PIT:

- First the top rate applies only to the rich, those earning over ten times the pay of an average production worker, whereas in most countries it would be around two to four times this amount.
- Second is the existence of an alternative minimum tax. Originally designed as a simple way of ensuring the rich pay some tax, this provision has now become complicated and through lack of indexation applies also to the middle classes.[77]

VAT was seriously considered as an alternative to CIT, in the 1960s. During the 1970s and 1980s VAT was proposed as a federal consumption tax that would enable PIT and CIT to be reduced. Since the late 1980s, however, VAT has not been on the political agenda, nor is it likely to be in the foreseeable future.[78]

Another feature of the US tax system is the extremely low tax component in motor fuel prices, alcoholic drinks, and cigarettes relative to other OECD countries.

In the United States, there is a major problem for tax reform as a result of the separation of tax powers not only between the Administration and Congress, but also between the Senate and the House, all three often producing different proposals.[79] Until a last minute agreement the famous 1986 Tax Reform appeared doomed for this reason. As Sunley and Stotsky (1998: 426) put it: "Since then federal taxation has been budget-driven and much less concerned with the fundamentals of taxation". This remained true until the beginning of the twenty-

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[76] MESSERE (2003)

[77] MESSERE (1998)

[78] SLEMROD (1996)

[79] SLEMROD (1996)

first century, when the Bush administration slashed top and bottom rates of the PIT, proposed to cut CIT rates, and increased defense expenditure.

4.2.2. Japan – Development of income taxes

The aim of this subchapter is to give a brief view of the Japanese tax system. For better understanding of the current tax system development, we should describe the process of tax reforms, which started in Japan, in mid 1980s of 19th. century. These changes have had a considerable impact on the functioning of the tax system. Thus, year 1887, when income tax was introduced by national government, can be regarded as the beginning of modern Japanese tax system. Although it took the modern form only in year 1940, Japan is still regarded to be the pioneer in using the income tax. Before income tax became dominant in the overall tax system, land tax and indirect taxes created the main part of government revenues. Personal income tax and corporate income tax became the major source of Japanese tax revenues only after the 1935. Short before the World War 2, Japanese government was still relying mostly on indirect taxes. And approximately two thirds of governments` total tax revenues were coming from these taxes. To prepare for the war economy, Japan has realized the overall tax system reform, in 1940. Whole Japanese tax system was strictly rebuilt, which has led to modern tax system based mostly on direct taxes. In the same year, personal income tax and corporate income tax have been distinguished, both with different tax rates. As a result of this tax reform, relative ratio of indirect taxes started to decrease. Further tax reforms were following in the post-war period.[80]

After certain time interval, one of the significant reforms was the reform of the tax system, realized under the Prime Minister Takeshita, in 1987. It consisted from the bundle of decreases of income taxes and elimination of saving system free of tax. Main aim of the reform of personal income tax was to lower the tax burden by drastic reduction of progressive tax rates (on national and local level). General

[80] In 1947, number of tax reforms took place under the influence of the American occupation authorities. In 1949, Carl S. Shoup group came to Japan; with the aim of reorganizing of Japanese tax system as a whole.

opinion has been spread out, that the reform of the personal income tax should be based on reduction of marginal tax rates through the income tax base widening.

Takeshita`s tax reform played a very important role, in the history of Japanese tax system. After this reform, which finished with an introduction of value added tax in April 1989, the patience was paid to the changes in consumption and land tax. Due to these reforms also reforms of the income tax started to work and have an impact on the Japanese economy. Since the beginning of 1990s, both personal income tax and corporate income tax have been part of gradual tax reductions as a tool of a fiscal stimulus.[81] Despite of stabilization programs by means of fiscal and monetary tools, Japan has had a positive growth till the year 1999. Also the consumption tax has, from its establishment achieved the constant growth, since its establishment in 1989.

During the post-war period Japan has been a low tax country. In the economic bubble boom of the 1980s the Japanese total tax ratio overtook that of the United States, but during the downturn of the 1990s it fell behind that of every OECD country (see Tab. 9), save for Korea and Mexico. Considering the income tax reductions that were made towards the end of the twentieth century and the fact that the recession is continuing, it appears that Japan`s TTR will continue to decline, but there are limits. In 1993, Japan, along with Korea, was the only OECD country with a budget surplus. At the end of the 1990s it had the largest deficit of OECD countries.

Japan's reliance on income taxes is below the OECD average (see Fig. 22), even though the share of CIT receipts is higher than that of any other OECD country (except Luxembourg), despite a considerable drop in the CIT ratio during the 1990s. The reason for this is the incorporation of small businesses by the self-employed. This has been encouraged by tax inducements. Since then, however, with the economic recession, both PIT and CIT shares have fallen. Social security contributions are well above the OECD average-perhaps a reflection of the fact that Japan faces big ageing problem. The share of property tax revenues is among the

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[81] These reforms were supposed to stimulate Japanese economy after the longlasting recession. This was a result of bursting a bubble and rates of real economic growth were approaching to zero.

highest in the OECD area and the share of consumption tax revenues the very lowest, with the exception of the United States.

For a unitary country the share of tax receipts allocated to local government is very large, but the latter has little discretion over the rates of these taxes.

An unusual feature of the Japanese PIT was the early creation of a schedular system, with especially low flat rates for interest income and capital gains, at a time when most OECD countries were moving to a global system. At various times attempts have been made to return to a more comprehensive tax base (as advocated by the Shoup committee shortly after the Second World War), but these have proved unsuccessful.

For virtually the whole of the post-war period Japan has been governed by different factions of the same party[82]. This is an explanation for the low TTR and the narrow base of both PIT and CIT. And it is also an explanation for the too long resistance to the introduction of VAT. When VAT was eventually introduced it was at the unprecedented low rate of 3 per cent (later increased to 5 per cent)[83].

At the beginning of the twenty-first century, Japan is also unique in the OECD area in having a deflationary rather than inflationary economy, not common since the Second World War.

Income tax

Main source of revenues are for the Japanese government personal income tax and corporate income tax. Both of them created approximately 35 per cent of government revenues from taxes and other receipts, in 1988.[84] In 2003, it was 30,6 per cent of total taxation.85

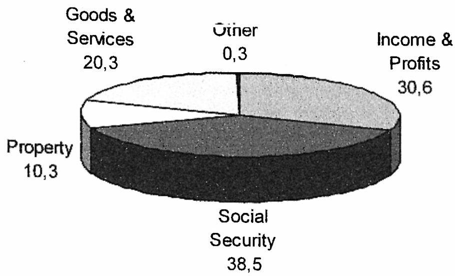
[82] which largely represented business interests

[83] MESSERE (2003)

[84] TAKATOSHI (1992)

[85] OECD: Revenue Statistics (2005)

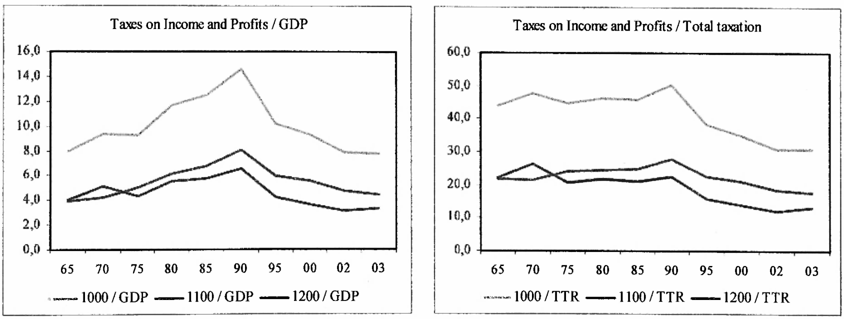
Fig. 20 Tax revenue of main headings as percentage of total taxation, Japan 2003



Source: OECD Revenue Statistics 2005, own graph

In the 2000 PIT alone, created just 21,1 per cent of total tax revenues.[86] And it is still continuously declining as shown in the Fig. 21.

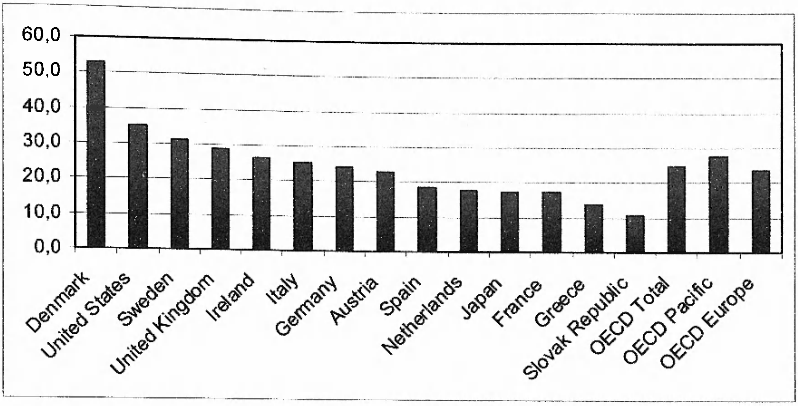
Fig. 21 Taxes on incomes and profits as percentage of GDP and Total taxation



Source: OECD Revenue Statistics 2005, own graphs

[86] OECD: Revenue Statistics (2005)

Fig. 22 Taxes on personal income as percentage of total taxation in the chosen OECD countries, 2003



Source: OECD Revenue Statistics 2005, own graph

Basic tax unit

In pre-war Japan family was considered to be a basic tax unit. It was due to the fact, it was generally believed, that the head of the family (mostly husband), is responsible for filling the tax refund for the common income (wife and children were depending on him). In 1949, Shoup`s tax mission recommended substitution of family unit by an individual. Since than, Japan became a country, where an individual became the basic tax unit, however certain exceptions have been approved. According this system are couples (both of partners working) taxing separately. In the couple with children, where just one partner is working, the head of the family is considered to be the taxpayer.

Tax system of Japan is similar to those in Australia and New Zealand, in which the individual is still more dominant. It is though in the sharp contrast with USA, United Kingdom and France. USA uses family tax unit with different tax rates for individuals and couples on the basis of distribution of income. Similarly, United Kingdom uses such tax unit, that after all deduction, income of the wife is added to her husband's income. France has a special system based on the system of quotients, which divide the household income between the family members. Because of its variety, connected to the use of tax unit, tax unit should not been able to cause serious problems, in Japan. So, in Japan married couples with the same incomes pay different taxes, depending whether they both work, or just one.

4.3. The Comparative View of the Selected Countries

The European experiences may be briefly summarized as follows. When we look at the structure and evolution of the European tax systems over the past 30 years, the EU area is peculiar compared with the main international experiences outside Europe (US and Japan) and, more generally, compared with OECD area. In the EU, the tax burden is, on average, higher than in the OECD area. European countries rely more on social security contributions and less on the consumption taxes. In social security sector is allocated the higher share of tax revenues and the lower share is allocated to sub-national governments. Taxes on labour and their contribution to total tax revenues are higher in Europe than in the OECD area. The European averages though show marked differences across individual countries. Tax ratios, tax structure and the allocation of revenues across levels of government differ markedly between selected countries. Up to the mid-1980s, country divergences increased considerably, while over the last 15 years the separation between individual countries has largely been reversed. Some common trends in the recent evolution of tax systems and policies may be identified, essentially a traditional rate-cutting, base-broadening reform. No radical tax reforms occurred, but some common issues have arisen in the discussion of tax design in the selected European experiences.

Equity. This issue has been rather neglected during the 1980s` season of reforms, when tax reforms paced more emphasis on efficiency than on equity. New tax measures tried to introduce limited horizontal equity objectives and reinforce progressivity. However, they have mainly concerned tax rate cuts not only for the bottom income levels, but also for the top levels.

Competitiveness. Competitiveness is one of the main objectives of many planned reforms, which aim at introducing tax measures specifically targeted to increase national competitiveness with respect to financial capital, real capital and other production factors (mainly labour).

Innovation. Tax bases have been broadened in order to introduce tax incentives to selectively stimulate innovation and growth in four areas, small firms, R&D investments, venture capital and stock options.

Fiscal relations across government levels. The structure of Fiscal relations across government levels is changing in all the analyzed countries, through the distribution of tax powers remains to be defined. Recent evidence predicts a lower redistributive impact of the whole system in the future.

4.4. Tax Systems-Structure and Developments

4.4.1. Comparison of the Tax Ratios of the OECD Countries

Tax ratio is standardly used for the comparison of the tax burden. Even if it is only a rough indicator of the tax burden across time and countries, the ratio of taxes to GDP is a useful scaling factor and a signal of the country's preference for the size of the public sector.[87]

The development of the tax ratio in Czech Republic and other chosen OECD countries is shown in the following table. According to OECD from the year 1970 till the 2000 (see the following table) tax ratios generally increased in OECD countries by about 9 per cent and in 15 EU countries by 11,2 percentage points. When we look closer to the statistics, we may see, that the above mentioned growth has been caused by EU countries, where the tax ratio increased from 30,4 per cent in year 1970 to 41,6 per cent in 2000.

[87] In the Czech Republic we distinguish tax rate "narrow"and "wide". It is due to the fact, that social and health insurance is sometimes not included into the tax revenues. (According to the interpretation of the Tax and tariff low it is not a tax revenue). From the tax comparation point of view insurance is considered to be unambiguous a tax revenue.

Tab. 9 Total tax revenue as a percentage of GDP

Year	1970	1975	1985	1990	1995	2000	2002	2003	2004 provisional
Czech Republic				47 %	40,1 %	39,5 %	37,0 %	37,7 %	37,6 %
Austria		37,7 %	41,9 %	40,4%	41,6 %	43,3 %	43,6 %	43,1 %	42,9 %
Belgium		40,8 %	45,8 %	43,1 %	44,8 %	46,0 %	46,2 %	45,4 %	45,6 %
Denmark		41,4 %	47,7 %	47,1 %	49,4 %	48,4 %	48,7 %	48,3 %	49,6 %
France[88]	34,1 %	36,9 %	43,8 %	43,0 %	44,0 %	45,5 %	43,4 %	43,4 %	43,7 %
Germany[89]	32,3 %	36,0 %	32,9 %	32,6 %	38,2 %	37,8 %	35,4 %	35,5 %	34,6 %
Hungary					42,4 %	38,7 %	38,8 %	38,5 %	37,7 %
Ireland	28,8 %	29,1 %	35,0 %	33,5 %	32,7 %	31,1 %	28,7 %	29,7 %	30,2 %
Italy	26,1 %	26,1 %	34,4 %	38,9 %	41,2 %	42,0 %	42,5 %	43,1 %	42,2 %
Poland					39,6 %	32,5 %	34,7 %	34,2 %	n.a.
Spain	16,3 %	19,5 %	27,6 %	33,0 %	32,8 %	35,3 %	34,8 %	34,9 %	35,1 %
United Kingdom	37,0 %	35,3 %	37,7 %	36,8 %	34,8 %	37,7 %	35,6 %	35,6 %	36,1 %
The Netherlands	35,8 %	41,6 %	42,6 %	43,0 %	41,9 %	41,4 %	39,2 %	38,8 %	39,3 %
USA		26,9 %	26,1 %	26,7 %	27,6 %	29,9 %	26,3 %	25,6 %	25,4 %
New Zealand		31,1 %	33,6 %	38,0 %	38,0 %	36,2 %	35,0 %	34,9 %	35,4 %
Japan		20,9 %	27,4 %	29,1 %	26,7 %	26,5 %	25,8 %	25,3 %	n.a.
EU 15	30,4 %	34,0 %	38,5 %	39,2 %	40,0 %	41,6 %	40,6 %	40,5 %	n.a.
OECD total	28,3 %	31,1%	33,8 %	35,0 %	36,1 %	37,1 %	36,4 %	36,3 %	n.a.

Source: OECD (2005)

The value of the tax ratio is in the Czech Republic above the average value of tax rate of OECD countries, while being slightly below the EU countries average.

For the selected 7 OECD countries (Ireland, Italy, France, Germany, Netherlands, Spain and United Kingdom) the rise in tax ratio has been lower than OECD average, about 8 percentage points.

Tab. 10 Total tax revenue as a percentage of GDP in 7 selected countries

Year	1970	1975	1985	1990	1995	2000	2001 provisional
7 selected countries	30,1 %	31,7%	36,9 %	37,7 %	37,9 %	38,6 %	37,9 %

Source: OECD (2002a)

[88] From 1992, the total tax revenue has been reduced by the amount of the capital transfer that represents uncollected taxes.

[89] Unified Germany beginning in 1991. Starting 2001, Germany has revised its treatment of non-wastable tax credits in the reporting of revenues to bring it into line with the OECD guidelines.

The tax ratio trend increase stopped in the 2000 and since then we may see slightly declining trend in OECD countries. The same was the case of the 7 selected countries after the 2000, till the 2002 apart from Italy the data show light decreasing trends in tax revenues.

The trends have been different over time and between countries. In the period 1970-2000, the ratio increased in six countries (Spain, Germany, UK, Italy, the Netherlands and France) and stayed constant in Ireland. The figures for Italy and Spain are the highest, in these countries; the 1970 ratios were the lowest. On average, both in the OECD countries and in the 15 EU countries, the main portion of these changes occurred during the 1970s and, to a lesser extent, during the 1980s. The pattern of individual countries has been different. In Italy, the increase in the tax-to-GDP ratio was higher during the 1980s than in the previous decade. In the 1990s, up to 2000, while the ratios decreased markedly in Ireland and the Netherlands, in France, Germany and Spain they were at that time increasing. In the same decade Italy registered the highest increase in the tax-to-GDP ratio (from 38,9 per cent to 42 per cent). The figures suggest that the tax ratios of individual states moved closer to the average. However, since the year 2000 the difference between the highest ratio (France) and the lowest (Ireland) still remains significant, more than 13 percentage points. In the EU area, the tax burden is on average higher than in the OECD area and the difference during the period 1970-2000 has increased from 2,1 to 4,2 percentage points.

4.4.2. Comparison of the Tax Structure of OECD Countries

Although tax-to-GDP ratio is simple and important for the comparison of the level of taxation between the countries, it covers just one aspect of taxation. It does not say anything about how is the structure of the tax ratio and from which objects are taxes levied. Taxes can be levied on these objects: Incomes (revenues), consumption and property. More subtle classification uses the OECD statistics, which divides taxes into six main groups[90].

As the total tax ratio has risen sharply, the tax structure by legal tax categories, measured as the distribution of tax revenue among major taxes (income

[90] Which are further divided into the subgroups

taxes, taxes on goods and services, social security contributions and property taxes, has changed over time (see Tab. 11).

The tax structure of the OECD area currently differs from that of the European area mainly in respect of two items: social security contributions (higher in the EU countries) and taxes on goods and services (lower in the EU countries). The differences between the two areas decreased though in the last two decades.

In EU 15 the tax mix in the 2003 was composed of taxes on goods and services (30,4 per cent), social security contributions (28,8 per cent), taxes on incomes and profits (33,2) and property taxes (5,2 per cent).[91] In the last two decades a shift has occurred from the personal income tax and social security contributions to the corporate income tax and property tax.

The seven selected countries vary in the importance of these main revenue sources. In the UK and Ireland, income taxes and consumption taxes account for a much higher share of total tax revenues, while social security contributions account for approximately half of the European average (see Tab. 11). Italy reflects exactly the average European model of taxation, while the remaining countries are all characterized by the fact that they rely heavily on social security contributions and less on the personal income tax (France, Spain, and Netherlands) or on corporate income tax and property taxes (Germany).

Tab. 11 Tax Structure: tax revenue of major taxes as a percentage of total tax revenue

	Personal income		Corporate income		Social security and payroll		Property		Goods and service	
	1980	2000	1980	2000	1980	2000	1980	2000	1980	2000
France	11,6	18,0	5,1	7,0	44,9	38,4	4,8	6,8	30,4	25,8
Germany	29,6	25,3	5,5	4,8	34,5	39,0	3,3	2,3	27,1	28,1
Ireland	32,0	30,8	4,5	12,1	14,5	13,6	5,3	5,6	43,7	37,2
Italy	23,1	25,7	7,8	7,5	38,6	28,5	3,7	4,3	26,5	28,4
Netherlands	26,3	14,9	6,6	10,1	38,1	38,9	3,6	5,4	25,2	29,0
Spain	20,4	18,7	5,1	8,6	48,6	35,1	4,6	6,4	20,7	29,8
United Kingdom	29,4	29,2	8,4	9,8	21,0	16,4	12,0	11,9	29,2	32,3
OECD total	31,3	26,0	7,6	9,7	23,5	25,7	5,3	5,4	32,3	31,6
EU 15	29,0	25,6	5,8	9,2	30,4	28,4	4,2	5,0	31,0	30,0
selected countries	24,6	23,2	6,1	8,6	34,3	30,0	5,3	6,1	29,0	30,1

Source: OECD (2002a).

[91] Source: OECD (2005)

Within the EU some countries (Tab. 9) show higher tax burden than the European average (France), while others are in opposite situation (Germany, Ireland, Spain and the UK), in 2000. In France this is explained by the relatively higher incidence of social security contributions and property taxation, while both corporate and income taxes are under the European average. We may find lower tax burden in Anglo-Saxon countries. It is mainly due to the incidence of social security contributions, while in Germany and Spain direct taxes and taxes on goods and services are under the European average. In the countries where tax-to-GDP ratio increased during the 1990s (France, Germany, Italy and Spain), the largest part of the increases has taken the form of higher personal and corporate income taxes (France), social security contributions and consumption taxes (Germany and Spain), while Italy used a mix of increases in the personal income tax, property and consumption taxes.

5. Future Tax Systems

5.1. Introduction

This concluding chapter offers a few guesses on how tax systems might evolve over the next fifteen to twenty years. Tax policies will to some extend depend on policy goals that governments want to achieve. Probably more relevant to future tax trends is what governments find it feasible to do in the tax area. Among the more important constraints upon them will be the state of their economy (rates of GDP growth and inflation and the level of employment), the impacts of economic integration within the European Union, the uncertain outcome of the continuous struggle between tax officials and tax avoiders and evaders, globalization, the ageing of population.

In this chapter, it is assumed that during the next fifteen to twenty years:

- the economic cycle, employment and GDP growth will continue much as in the last twenty years;
- inflation/deflation rates will be sufficiently close to zero as not to affect long term tax revenue trends substantially;
- the greater sophistication of tax officials and tax avoiders/evaders will more or less cancel each other out, so that these will have no great impact on overall tax levels.

These assumptions do not necessarily apply to any particular country. They just represent an overall assessment. For example, it may be that in countries with poor tax administrations the impact of their greater administrative sophistication will be offset by greater tax evasion through the Internet in other countries.

This chapter begins with what is likely to affect revenues from the main taxes, and next continues to some forecasts about what might happen to overall tax structures and tax levels. The chapter then addresses the related question of whether the forces making for convergence of tax levels, tax structures and tax rates are likely to prevail over those than can make for divergence.

5.2. *The Future of the Main Taxes*

Personal Income Tax

In my opinion, most industrialized countries will remain with the personal income tax (PIT) as one of their major sources of revenue. Country changes will doubtless vary according to their present tax system and the political, social, and economic preferences of their governments. Much of the trend of the 1980s and early 1990s reflected the presence of governments of the radical right in the United Kingdom and the United States and some temporary replacements of social democratic regimes in Scandinavia.

During the late 1990s left wing governments came into power in some of the major European economies with slight increases in PIT ratios, as also happened under the Clinton administrations in the United States. Overall, however, the share of PIT revenues in GDP and total tax revenues fell during the 1990s. On the contrary, with the development of communications technology, PITs are probably going to be more difficult to collect. More and more employees, previously subject to withholding tax on their wages or salaries, will become self-employed, working at home on their computers, with all the possibilities of reducing tax liabilities that such a change in economic status will provide.

A distinction between taxing labour income and capital income should be made. It is not very likely for most workers in industrialized countries to be geographically mobile between countries over the next fifteen years or so, whereas the sources of capital income are already mobile.

It may be assumed that more countries will follow the mini-trend of partial integration of PIT and social security contributions and PIT and transfer payments via non-wastable tax credits, in order to reduce the poverty and employment traps and tax discrimination against low paid labour.

Corporate Income Tax

Over the last forty years, corporation tax revenues have remained more or less stable on average as a percentage of GDP, though there have been many short-term country fluctuations reflecting political preferences and the state of the economy.[92]

It would not be surprising if the rate-lowering, base-broadening trend that began in the mid-1980s were to continue. Rate-lowering because this is where domestic pressures are concentrated, which are reinforced by international competition. Base-broadening because of revenue needs.

Radical change of the tax system creates many complications and is never undertaken lightly, so that it seems unlikely that the fashion of the 1970s and early 1980s for partial integration of corporate and PIT via imputation systems will be revived.[93]

More countries may be heading towards introducing a variant of the „classical system" with lower nominal CIT rates and dividends subject to a flat PIT rate. The EU Commission made proposals in 2001 to harmonize the CIT base of its fifteen Member States, but it seems unlikely that these will be accepted.

Social Security Contributions

It seems probable that the trend over the last forty years to implement an income support approach will persist. Much depends on how far governments can continue to find mileage in the social insurance approach in persuading their citizens to increase payments.

It seems doubtful whether the future workforce will continue contributing as large a share of tax revenues as has been the case in the past. Working generations may also be satisfied with the idea of greater individual entitlements to social security, with a likely shift from public pay-as-you-go systems to privately or publicly funded provisions.

Consumption Taxes

It seems that the value-added tax is going to stay the general consumption tax of all countries, except the few (India, United States) where the existence of sub-national

governments` sales taxes is probably the main reason for its absence.

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[92] OECD Revenue Statistics (1965-2004)

[93] MESSERE (2003)

EU Directives will continue to influence government choices (of whether the base should be extended and whether a single rate should be adopted) in the twenty-five Member States of the European Union, but domestic political pressures will probably take precedence.

Small increases to the standard rates of tax, which usually apply to the great majority of goods and services, have occurred in nearly all VAT countries over the last thirty years and, as this is probably the easiest and least painful way of increasing government revenues, will most probably continue to do so.

Pressures may increase to subject environmentally friendly and labour-intensive economic activities to reduced rates of VAT. Evasion of VAT as well as income tax through manipulation of the new electronic commerce is already taking place and is likely to increase, and evasion of VAT on domestic services will also doubtless continue.

Property and Capital Taxes

The future of net wealth taxes looks doubtful, given the fears of capital flight that appear hard to stem even with improved exchange of information between national tax administrations. Taxes on bequests yield relatively little revenue and are frequently avoided, and their future may also be insecure, as suggested by their recent removal in Italy and the United States.[94]

The future of the taxes on immovable property is very much bound up with the relative taxing powers of national and sub-national levels of government, something which varies greatly from country to country and is likely to continue to do so in the future. This is a revenue source recently (re)discovered by a number of countries and its share in tax revenues may well increase since, unlike capital and its owners, land and buildings are not mobile. On the other side, highly visible property taxes are unpopular with the electorate and politicians may decide it is wiser to reduce such taxes, or even not to raise them.

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[94] OECD (2005)

5.3. *Will tax systems converge?*

A distinction should be made between tax levels, structures, rates and systems of countries coming closer together (tax convergence) and exhibiting common trends. It is evident that terms, such as convergence and harmonization are not synonymous in this context.[95]

There are at least four separate reasons for believing that a convergence of the different tax levels and structures of countries will occur. First, to gain taxpayers` consent to increased levels of taxation, diversification of revenue sources may be necessary. Second, international tax competition may force income tax rate to its reductions. Third, the development of the electronic communications technology is likely to transform the markets for consumer goods and labour of most industrialized countries. With such consequences, some kinds of tax will be more difficult to collect than others. Fourth, there is the EU Commission's insistence that, as long as the tax levels and tax structures of Member States remain so diverse a single economic market is unachievable.

Different questions include how far globalization and other international factors are likely to compel tax convergence or continuation of common trends both within the European Union and among industrialized OECD countries generally. Question is also, how far are national governments likely to remain free to take their tax policy decisions exclusively or primarily on domestic grounds. Importance of these international factors on tax convergence in the recent past has been somewhat exaggerated, though they have been partially or even largely responsible for certain common trends.

As regards the European Union there remains much resistance among Member Country governments to take particular decisions that would be unpopular in their own countries. Initially, tax convergence prevailed, largely as a result of previously low-taxed countries of Southern Europe catching up on the more highly taxed countries of North and Central Europe. This trend was discontinued during

[95] For example, if VAT rates and revenues increase by more than the rates and revenues of other taxes, and this happens to countries with an already above average reliance on VAT revenues and above average VAT rates, this would represent divergence between such countries and other countries, and not convergence.

the 1990s when there are some clear indications of tax divergence between EU Member States, with increases in the TTRs of some highly taxed countries and a slowdown in some lower taxed countries in Southern Europe.

It seems that EU membership does not have too much influence on rate convergence. For example, there was no convergence of VAT rates between 1987 and 1995 in the EU.[96] Also, there are a number of recent examples of EU country governments insisting on retaining their tax sovereignty. Under the 1992 EC Rates Directive, countries with zero VAT rates on certain goods are entitled to keep them for a 'transitional period', but the abolition of zero rating on around a quarter of UK consumer expenditure has never been on the agenda of either the previous or present British government. The detrimental effects of widely differing excise rates between neighboring countries in terms of economic distortions and significant revenue losses due to legal and illegal cross-border shopping are well known. However, a drastic change to excise rates in the countries involved (e.g. Denmark, France, and the United Kingdom) would apparently pose even greater problems for their governments, since there have been no clear signs of high-excise countries decreasing or low-excise countries increasing excise rates.

There are some opinions within the EU suggesting that taxes should be harmonized in the European Union[97]. The way in which supporters of tax harmonization tend to think is, however, severely flawed. EU member states should even in the future be allowed to set taxes on a national level. Free decision on national tax rates and consequently tax competition are beneficial for a number of reasons. These benefits will be illuminated onwards.

Those who oppose tax competition[98] often refer to the welfare costs of harmful tax competition that creates fiscal externalities on neighbor countries such as tax base flight to escape high taxation. A number of German companies for instance have threatened to transfer production to Eastern European countries due to the tax and wage cost benefits. Therefore supporters of tax harmonization argue

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[96] KEEN and SMITH (1996)

[97] supporters of the idea of the Single Market

[98] Gordon Brown, Chancellor of the Exchequer, has made it clear in speeches and newspaper articles that the UK will resist proposals to harmonize direct tax regimes across the EU. The UK will also resist any attempt to introduce majority voting on tax issues, insisting on retaining its veto (International Tax review).

a race to the bottom will eventually occur. This assumption is, however, doubtful since lowering taxes is mainly an important instrument for emerging economies to stimulate economic growth. Nevertheless in the foreseeable future there will be a growing demand for public spending in the new member states, coming from different sources, e.g. improvement of the infrastructure. Thus a race to the bottom is highly unlikely as they will need to raise taxes in order to afford the improvements. Moreover, tax competition is beneficial for the entire European Union since it forces governments to charge efficient tax prices for their public services.

Tax Harmonization vs. Tax Competition

It is frequently argued that the purpose of tax harmonization is to prevent unfair competition. Occasionally, supporters of tax harmonization refer to this as *fiscal dumping*.[99] France and Germany hence feel that they have to harmonize corporate tax rates by setting a minimum rate applicable across the European Union to avoid such fiscal dumping. A number of new member states of the European Union such as Slovakia reduced tax rates and as a result they have been able to attract increasing volumes of investments from European and American multinational companies. Such foreign investments are essential for the future of these emerging market economies.

Since tax matters have to be decided unanimously in the European Union, it is highly unlikely that tax harmonization will be accepted by new member states experiencing high economic growth rates. Therefore, the most obvious purpose of recent statements from French and German politicians is presumably to encourage Eastern European to raise their corporate taxes. Nevertheless, their actual influence on the tax policies of these countries is limited, even though these West European countries are net contributors of the EU budget and can thus threaten to decrease regional aid. Germany for instance has noted that new member states receive billions of euros in infrastructure, agricultural, and other subsidies from the EU budget which is largely funded by German citizens, i.e. taxpayers. The German

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[99] Germany has reopened the ongoing debate about European tax harmonization. It accused neighboring Austria of fiscal dumping in order to poach investment from companies looking to lower their tax burden (Tax-News.com)

Economics Minister Wolfgang Clement has recently said he might demand cuts in the subsidies if the new member states do not raise their taxes.[100] The budget is in fact the good way in which a country like Germany could somehow influence the tax policy of the new member states. Similar comments have been made by Nicolas Sarkozy, the former French Finance Minister.[101]

Eastern European economic growth has, however, become a reality not only due to low taxes. Low labour costs and a relatively efficient productivity also add to the region's appeal to foreign investors. This aspect also needs to be considered in the ongoing debate.

Furthermore, it is imperative to emphasize how lower taxes help new members of the EU attract more businesses so they can catch up with the rest of Europe and the rest of the industrialized world. The best way to increase tax revenues is definitely encouraging business growth, not forcing states to increase their corporate tax rates. On the contrary, Germany could learn a lesson or two from the Eastern European pro-growth tax policy and how tax competition and fiscal reform can stimulate the economy.

Since harmonized tax rates eliminate fiscal competition, much like a price-fixing agreement, it hinders the efficient allocation of capital and labour, slowing overall economic performance.

Tax competition, on the other hand, facilitates economic growth by encouraging policymakers to adopt sensible tax policy. It is not a big surprise that high-tax nations dislike tax competition (Germany, France), since they tend to be the ones suffering most of such competition. Tax harmonization is mostly associated with higher fiscal burdens.

Academic research in the field of tax harmonization (presumably with a high fiscal burden) vs. tax competition clearly indicates that tax competition is more beneficial with regard to economic growth. There are also a number of examples from the real world that widely corroborate the academic evidence. Among such examples are the Thatcher/ Reagan tax rate reductions.

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[100] www.businessweek.com

[101] According to http://news.bbc.co.uk, Sarkozy said that those EU countries with lower taxes than old Europe should not receive EU subsidies.

In more recent European history, the Irish miracle is a notable example of the benefits of tax competition. The corporate tax rate reduction in Ireland has yielded remarkable results. Less than 20 years ago Ireland was known as the "sick man of Europe" with high unemployment. Corporate tax rates were around 50%. In the 1990s tax rates were slashed. The corporate tax rate in Ireland is today only 12.5% and these tax rate reductions have yielded enormous benefits to Ireland. The economy grew by an annual average of 7.7% in the 1990s. During the late 90s the economic growth was particularly impressive with over 9% growth. As a consequence Ireland has become the "Celtic Tiger" in a relatively short time. The Irish example has also encouraged other European countries to drop their tax rates. According to the Wall Street Journal average corporate tax rates have dropped to 30%.[102]

Some Eastern European countries, such as the Baltic nations, introduced flat tax rates in the 1990s. Russia followed suit in 2001, Slovakia in 2004. And good tax policy is having a desirable impact in these countries. Not only have foreign investors been attracted to the new member states, but tax compliance has also improved significantly. Inflation adjusted income tax revenue in Russia for instance, has grown by about 60%. It seems as if people are willing to produce more and pay their taxes when the system is less opaque and tax rates are low. A sudden tax harmonization with a higher tax level would be harmful to these currently prospering countries.

Tax Harmonization and Economic Theory

Supporters of tax harmonization frequently refer to the theory of Capital Export Neutrality and argue that in a world with no taxes the most efficient allocation of resources based on economic criteria will occur. Thus tax harmonization is required to prevent distortions of competition, particularly of investment decisions and to create a level playground. Nonetheless, most economists argue that the economic benefits of tax competition and lower tax rates enhance economic efficiency. There is strong evidence that the economic benefits

[102] The Irish Taxation Institute

of lower tax rates exceed the theoretical economic cost of the misallocation of resources associated with different tax rates.[103]

Furthermore, economic theory states that competitive markets result in price convergence since producers discover that they will lose customers if they charge more than the market price and lose earnings if they charge less than the market price, thus tax rates will tend to converge and concerns of a race to the bottom are hence not justified.

Tax harmonization is in essence designed to hinder the flow of capital and jobs from high-tax countries to low-tax countries and to protect countries with high tax rates such as Germany and France. Precisely this policy is, however, contrary to economic liberalization and means less economic growth for the region.

Tax competition, on the other hand, encourages the government and policy makers to make the right decisions effectively. Moreover, flat tax rates seem to be the best way to stimulate an economy as seen in the new EU member states. To eliminate the right for these states to determine their fiscal policy, especially during their period of catching up to the Western European states would be a severe setback for the whole region and its economic growth prospects.

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[103] International Tax Review, Herbert Smith *UK: Chancellor rejects tax harmonization*

Below are the corporate taxes of some EU member states:

Tab. 12 Corporate tax rates in OECD countries

Country	Corporate Tax Rate in 2000	Rank in 2000[104]	Corporate Tax Rate in 2006	Rank in March 2006[105]	Percentage Reduction in Corporate Rate
Germany	52.0	1	38.9	3	-25.2%
France	37.8	7	35.0	5	-7.4%
Belgium	40.2	4	34.0	7	-15.4%
Italy	37.0	9	33.0	8	-10.8%
Greece	40.0	5	32.0	10	-20.0%
Netherlands	35.0	11	31.5	11	-10.0%
Luxembourg	37.5	8	30.4	12	-18.9%
Denmark	32.0	18	28.0	17	-12.5%
Portugal	35.2	10	27.5	20	-21.9%
Czech Republic	31.0	19	26.0	22	-16.1%
Finland	29.0	24	26.0	22	-10.3%
Austria	34.0	14	25.0	24	-26.5%
Poland	30.0	21	19.0	26	-36.7%
Slovak Republic	29.0	24	19.0	26	-34.5%
Hungary	18.0	30	16.0	29	-11.1%
Ireland	24.0	29	12.5	30	-47.9%

Source: *OECD data as of March 29, 2006, located at http://www.oecd.org/dataoecd/26/56/33717459.xls.*

It is worth noting that tax breaks for the largest companies are common in some countries. Various loopholes also lead to the fact that effective corporate taxes often differ from the official corporate tax rates. A flat tax rate would simplify the calculation of tax bills. The supporters of tax harmonization nevertheless most often argue that those countries with low corporate taxes should raise their taxes and harmonize taxes at the German/ French level, not at the lower level of the new member states. For this reason tax harmonization is often associated with higher taxes and a harmonized low corporate tax rate is not even considered feasible.

Conclusion

Recent empirical research indicates that higher marginal tax rates and progressive tax systems have a negative impact on economic growth in industrialized countries. Germany and France are prime examples. Irish and Eastern European economic growth rates, on the other hand, are real world evidence of the success of lower corporate taxes. In the ongoing debate about tax harmonization in

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[104] Rank of all OECD countries

[105] Rank of all OECD countries

the European Union, supporters of tax harmonization are mostly associated with a higher fiscal burden, meaning higher corporate tax rates, while those in favour of tax competition are most often supporters of lower tax rates. It is obvious that West European countries at least to some extent criticize tax systems of Eastern European countries for unfair tax competition to divert attention from the urgent need to clean up their own tax systems. Therefore it is highly important to keep in mind the real interests and motives of the protagonists in this debate.

Furthermore, tax harmonization may lead to a democratic deficit of the EU member states since national decision-making would be seriously compromised if tax harmonization was implemented. The monetary policy of EU member states is already being conducted by the European Central Bank in Frankfurt. If member states were to lose control of their fiscal policy in addition to not being able to determine monetary policy on a national level, the consequences could be severe for the economic growth of the whole region.

In order to support the economic growth of the new EU members it is important to maintain the current right to determine corporate taxes on a national level. Member states must be allowed to use this instrument in the future in order to stimulate growth if a country wishes to do so. Different tax policies are required at different stages of development and especially in the European Union the member states are not at equal stages of development.

Apart from the influence of the European Union, there is little evidence that other international factors (such as economic globalization and international tax competition) have until now dominated domestic tax policy choices, with several important exceptions. International factors have been mostly responsible for the almost universal reduction of nominal top rates of the PIT and of PIT rates on capital income, for the reduction of nominal corporation income tax rates in many countries as well as the fall in net wealth taxes.

There has been one major example in recent times of one country's changes provoking similar changes in a number of other countries. That is the rate-lowering and base-widening of the personal and corporate income tax in the 1986 US Tax Reform Act.

We may wonder how much effect the tax competition aspect had when such major economies as France, Germany, Italy, and Japan[106] did not follow the example set by the United States until ten to fifteen years had passed. It does appear to be the only major case in the 1985-2000 period of one country's tax legislation influencing directly those of many other countries.

[106] Canada, which probably had no other choice, followed USA.

6. Conclusion

The primary aim of the paper was to examine tax developments of the OECD countries over the last forty years. The OECD experiences may be briefly summarized as follows:

Between most of Europe and industrialized OECD non-Europe there has been a wide difference of the role of government, which has accelerated over the last three decades. European countries[107] have been much closer to the question of welfare state and this is shown most clearly in differences in their total tax ratios. Fifty years ago there was some correlation between total tax revenues levels and GDP per capita. This is now far from the case, when relatively poor countries like Greece and Portugal have a higher TTR than Japan and the United States. Another major difference between OECD Europe and industrialized OECD non-Europe is the tax structure.

When we look at the structure and evolution of the European tax systems over the past 30 years, the EU area is peculiar compared with the main international experiences outside Europe (US and Japan) and, more generally, compared with OECD area. As the thesis has shown, the tax burden is in EU, on average, higher than in the OECD area. European countries rely more on social security contributions and less on the consumption taxes. To a much greater extent, non-Europe relies on different revenue sources, personal income taxes and taxes on real estate.

Taxes on labour and their contribution to total tax revenues are higher in Europe than in the OECD area. The European averages though show marked differences across individual countries. Tax ratios, tax structure and the allocation of revenues across levels of government differ markedly between selected countries.

How far are globalization, and other international factors likely to compel tax convergence or continuation of common trends both within the European Union and among industrialized OECD countries generally? Question is also, how far are

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[107] except Ireland and Switzerland

national governments likely to remain free to take their tax policy decisions exclusively or primarily on domestic grounds.

The base-widening and rate-lowering of the income taxes may well continue over the years to come. Good arguments remain for such moves and in addition, the public, the media and politicians seem more concerned with nominal rates than with the less transparent tax base.

In conclusion, it can be said that the few common trends may well continue, but otherwise there is no reason to believe that the tax structures of countries will come much closer together over the next ten to fifteen years. It may be expected that governments will continue to make most of their choices on tax matters largely on domestic grounds. They will also make their decisions without much reference to the choices of other countries or international developments, including those in the European Union. Judging by the recent past, future convergence of revenue trends seems more likely than divergence. However, divergence will sometimes occur because, for example, low-tax countries like Australia, Japan, and the United States might prefer to make smaller increases (or even larger decreases) to their total tax ratios compared to other countries.

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Thesis

Development and Differencies in Structure of Tax Revenues in the OECD Countries, with an Emphasis on Personal Income Tax.

Characteristics:

Master Thesis will examine tax systems developments of the OECD countries. It will also describe similarities and differences between the main choices of the OECD countries, with regard to tax levels, structures and systems. The paper will also try to pick up some choices made by particular countries, not to be found elsewhere.
The paper will provide comparisons between the countries, concentrating in particular on how far common trends and attitudes have emerged, how far countries have gone their own way and seem likely to continue to do so over the next few years. It will further point out differences in structure of tax revenues in the chosen OECD regions.

Methodology

- Data collection
- Distribution and sorting out the data into particular units
- Outline
- Description of particular tax systems
- Similarities and differences
- Questions, answers
- Summarization
- Conclusion

Outline of the work:

- Abstract
- Contents
- Introduction
- Description chapters
- Core - differences in structure of tax revenues
- Tax reforms, differences
- Essessment
- Conclusion

Literature:

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